183

NAFTA AND PESO DEVALUATION: A PROBLEM FOR U.S. EXPORTERS?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC., MAY 20, 1993

Printed for the use of the Committee on Small Business

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NAFTA AND PESO DEVALUATION: A PROBLEM FOR U.S. EXPORTERS?

THURSDAY, MAY 20, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order.

This morning the Committee on Small Business meets to ask the question, "Wither the Mexican peso?" The answer, of course, can have a profound impact on U.S. exporters and investors doing business with Mexico, especially the small business communities. In a NAFTA hearing this committee held on February 25, one witness—a distinguished Mexican economist, Dr. Jorge Castaneda—raised the peso issue. He said that NAFTA could play a nasty trick on those expecting a large U.S.-export payoff if, in fact, the agreement is followed by immediate devaluation of the Mexican peso. We convene today to explore this issue with a panel of experts.

Surprisingly, despite the endless discussions of NAFTA and the advertised potential export and investment benefits to U.S. business, few voices have been heard about the peso-dollar relationship and exchange-rate risk. Yet, since 1981, the peso has fallen from 25 pesos to the dollar to a current 3,200 pesos to the dollar. That is quite a decline. Mexico's exchange-rate policy has gradually devalued the peso since January 1989. Between 1989 and November 1991, the peso was devalued daily; in November 1991, the Mexican Government established a band with upper and lower limits subject to a managed float. The peso had been allowed to continue devaluing by widening the band on the devaluation side. In January of this year, the Mexican Government created the new peso by moving the decimal, so we now have New Pesos 3.27 to $1 U.S. dollar.

The reviews on the peso's future, or more precisely, the Bank of Mexico's policy, are mixed. There are those who say a major devaluation is inevitable. Gary Hufbauer at the Institute for International Economics, who strongly supports NAFTA, reportedly anticipates a substantial devaluation next year in the range of 10 to 20 percent. Others predict that a forced devaluation might occur this fall if capital inflows become insufficient to finance Mexico's growing current account deficit. Those who contend that a sharp de-

valuation will not occur, such as the World Bank staff, believe that Mexico will continue to devalue by widening the band on a daily basis but at a faster speed.

What are the economic trends in Mexico and what are the economic conditions that would foster a sharp devaluation versus a continued or accelerated daily devaluation? Mexico's current-account deficit is rising and this year is expected to reach $27 billion or 8 percent of GDP. This, of course, partly mirrors the jump in United States exports to Mexico—over $40 billion last year, depending upon which reports you believe—most of which are capital goods fueling Mexico's rising investment. Interest rates are high, about 17 to 18 percent, to draw in needed capital to cover the deficit as well as to hedge a devaluation risk. High interest rates, however, not only pull in external capital; they also put a drag on the economy. If the deficit widens faster than the inflow of capital to finance it, the Mexican Government will have to decide what to do about the peso, and it will not be an easy decision.

Devaluing the peso will make Mexico's exports more competitive; but it also might discourage imports of capital goods. Expectation of a sharp devaluation could also dampen new investment. Expectations of depreciation flag a currency risk and the need for a higher return on investment to compensate for expected loss. What of U.S. investors already established in Mexico? There are those who contend that the lack of concern by the United States and other transnational corporations about future peso devaluation indicates their disinterest in selling to the Mexican domestic market. Instead, it is their sales in other than currencies, especially dollars, that matter to them; and a cheap peso could help them sell exports from Mexico.

The exchange-rate relationship between the dollar and the peso will profoundly affect how any NAFTA operates and the distribution and nature of the benefits and burdens of NAFTA. Yet NAFTA establishes no mechanism to coordinate monetary policy between the United States and Mexico, nor does it provide for consultations or corrective measures if exchange rates are used to promote competitiveness. I believe it is imperative that both the United States and Canada consider a fourth supplemental agreement, one that recognizes the importance and impact of exchange rates on the operation of NAFTA.

Now, this is not new to me. I must add that the 1988 Omnibus Trade and Competitiveness Act contains a provision that I authored that requires the Department of the Treasury to annually analyze whether foreign countries are adjusting exchange-rate policies to gain unfair competitive advantage. It further requires the President to coordinate and confer multilaterally with other industrialized nations on macroeconomic policies. This we do with the G-7, a large part of which includes discussions on exchange rates and policy coordination. The 1988 Act I authored also requires the Treasury Secretary to engage in bilateral negotiations on exchange-rate policies used by countries which lead to an unfair trade advantage.

When we considered the Canadian-American FTA, I conducted about a dozen hearings just on that issue. I met many, many times privately with Peter Murphy, the U.S. Ambassador, and I tried

very hard to get such a provision in the Canadian-American FTA. I didn't see how we could have a free trade agreement unless we dealt with the exchange-rate issue. I was unsuccessful in that endeavor. If you trace the flows of trade between the United States and Canada, you will see a direct relationship to the values of the Canadian-American dollar and the type of account that we are running - it is a perfect symmetry. Now the exchange rate difference with Canada is within a very narrow band thus far, both prior to and post-Canadian FTA. It nowhere approximates the huge devaluation that we have seen in the Mexican peso circa 1980-81 to the present, nor does it in any way approximate the traditional type of precipitous devaluations that we have often seen in Latin America.

I know that the Salinas Government does not want to do this. I know that it is something to be avoided, but if we are going to have a NAFTA, wouldn't it be wise to have a provision in NAFTA that solidifies what might be the present intent that deals with this? I think it is crucial that we do.

I might add that this currency problem is proving to be a major challenge to the European Community's monetary union, as we saw last week when Spain and Portugal announced major devaluations. I believe it is prudent to make provisions in conjunction with NAFTA that call for coordination to achieve currency stabilization goals. Perhaps we should consider an EC - like band as a guide that would trigger a consultation, coordination, and corrective mechanism if necessary.

This is extremely complicated, and I am pleased that we have a very, very distinguished panel of experts of very diverse points of view. I am hoping you might be able to come to closure, though, if not on what is going to be the future of the peso, on whether we should have provision for it within the NAFTA via a supplemental. I would think that is something we might be able to agree upon.

We have Dr. John Williamson, Senior Fellow at the Institute for International Economics - I have been in forums discussing your books; Rogelio Ramirez De la O, president of Ecanal, S.A., Mexico City; Dr. Roberto Salinas-Leon, executive director, Center for Free Enterprise Research, Mexico City; Mr. Carlos Heredia, visiting economist from Mexico City, presently with the Development Gap; Dr. Rudiger Dornbusch, professor of Economics at MIT; Dr. Jerome Levinson, visiting fellow at the Economic Policy Institute; and Dr. Gregory Woodhead, economist with the Task Force on Trade, AFL-CIO.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. I look forward to hearing from all of you.

Does anybody else have an opening statement?

Mrs. Meyers. Mr. Chairman, as you know, I tend to agree with your thinking on the NAFTA issue, and in the interest of some evenhandedness today, I am going to defer to Mr. Baker to lead off with an opening statement for this side of the aisle.

There are varying opinions on the NAFTA agreement among the Republican Members. I think many of them do support it, and therefore we will begin by hearing Mr. Baker's opinion on NAFTA this morning.

Before he begins, I would like to thank you and your staff, particularly Marilyn Seiber, for accommodating the request of Mr.

Manzullo and arranging to have his requested witness, Dr. Salinas-Leon, testify before us today.

I would like to ask to have my opening statement entered in the record, and that of Mr. Ramstad, please.

Chairman LaFalce. Without objection, so ordered.

[Mrs. Meyers' and Mr. Ramstad's statement may be found in the appendix.]

Chairman LaFalce. The hearing I held today was based on an assumption that if NAFTA passes, it ought to be that the NAFTA we come up with and that we ought to be considering - on the assumption that NAFTA is going to pass - we accept that as an operating assumption without conceding that it might be necessary to deal with the question of the peso via some supplemental. So whether you are for or against NAFTA, if it is going to be a good NAFTA, we should deal with the issue of the peso in some appropriate way.

Mr. Baker.

Mr. Baker. Thank you, Mr. LaFalce and Mrs. Meyers, for your extending the privilege of making an opening comment.

Mr. Chairman, I do appreciate the interest and direction of this morning's hearing with regard to the complex question of currency exchange rates and possible future effects on free trade agreements if Congress so chooses to ratify. I think one of the important elements of the debate this morning should be whether or not the expected demise of trade relations, based on some future deterioration of the value of the peso, is in fact an element that we should be concerned about as of this date.

More important, in my view, is the fact that with U.S. companies, with frequency, locating their business operations in Mexico today, that we do enjoy an extraordinarily interconnected trade relationship and that some sources indicate as much as two-thirds of existing trade activity is already deregulated, which leads to the issue of what the further and last step of an agreement and open trade relationship might do.

Some have argued that the devaluation of the peso would only further escalate the utilization of a Mexican launching pad for export of product and does not further the quality of life in either the United States, with job development, nor create opportunities for those in Mexico as a result of devaluation. My perspective on that issue is that it is without basis at this time.

If you look to the gross domestic product of the Mexican economy, the 1992 current - account trade deficit was about $22 billion dollars, or 7 percent of their total gross domestic product of $300-plus billion. In looking at the effect on international trade relations between the United States and Mexico and possible escalation in manufacturing agreements that might result from a NAFTA, one then has to question the effect of any devaluation being of any consequence or long-term effect on the U.S. economy or our trade relationships.

More importantly, I think the determination as to why American business might go today to any outside country in which to operate its manufacturing base goes to the issue of our own Government regulatory policy, that many companies now find it more economically advantageous to locate in another market in another country

rather than face the heightened tax obligation, regulatory burden, and general government interference in business activity in the United States; and that if we are truly looking at the free trade agreement as an opportunity for business growth here and in other countries, that the bigger and more important element is deregulation of Government interference in business activities; and that if we truly expect a free trade agreement to work, that business regulation has to be minimized on both sides of the border.

I feel the free trade agreement moves us in that direction, and the question of deregulation of the peso, although of some concern, should be viewed much the same as our own stock market. It is a volatile circumstance over which no one unilateral force has direct control. It is a complex formula which results in specific market corrections based upon world market conditions. I certainly hope our own market stays at the 3,400-point level or higher, but no one would predict tomorrow or next year what that level might be.

Perhaps one of the most determinant factors in our own stock market's performance may well be the Clinton administration's regulatory plans and tax policies over the next 6 months. Why should any other country's market response be different from our own?

No, we should move ahead with the Free Trade Agreement. We should minimize government regulatory interference. We should allow American businessmen to make economic decisions and Mexican businessmen to make economic decisions based upon not only what is best for their employees, but what is best for their country's future. I think, by so doing, both will enhance their economic opportunities, enhance employment opportunities, and enhance the quality of life for both interests.

Thank you, Mr. Chairman, for allowing this brief opening statement.

Chairman LAFALCE. Thank you Mr. Baker.

Both Mr. Baker and I have given rather lengthy opening statements. I am anxious to hear from the seven witnesses, but I would recognize any Member who wishes to make either a very short opening statement or to have their opening statement inserted in the record as if read.

Mr. Klink?

Mr. KLINK. My feelings about the current NAFTA agreement are well known. I ask unanimous consent to have my statement submitted for the record.

[Mr. Klink's statement may be found in the appendix.]

Mr. FLAKE. Mr. Chairman, my brief opening statement will be more brief than yours and Mr. Baker's brief opening statements. I would like to welcome our witnesses this morning, and we look forward to hearing from them. I think it is very important for us to further our knowledge of this issue, as we try to examine all of the implications of NAFTA.

My colleagues and I have heard many statements made from the Floor and perhaps some of which is convolutes. Therefore, it is my hope witnesses will bring about a degree of clarity which will allow us to look at NAFTA with some objectivity.

It is an extremely important issue. Its consequences are dire and we cannot afford to move to abruptly without taking the time to

understand its political, societal, and its economic implications. We must adequately scrutinize the proposal to determine its effects on all nations that are involved in this process. More importantly, we must determine the impact on the people of these nations.

With that in mind, I am interested in the views of our witnesses as they relate to peso devaluation; and should the peso be devalued, what would the effect of that devaluation be on U.S. businesses. Many of the small business owners in my community have expressed a great deal of apprehension about whether we should enter into the NAFTA agreement. Therefore, I come today with some of their feelings and yet with some degree of objectivity in the hope that over the long term we might be able to allay many of these fears. At the same time we must move in the best interest of this Nation, Mexico, and Canada. However, we must understand that within this country there is a "third world" that has been created by neglect that is in evidence in almost all of our urban communities. If the NAFTA agreement does not in some way address these problems, I would find some difficulty in supporting the NAFTA proposal.

So, Mr. Chairman, I look forward to these witnesses and hope that we can move forward in a way that is in everybody's best interest if indeed we are to accept the NAFTA agreement.

Thank you, Mr. Chairman. I yield back.

Chairman LAFALCE. Is there any other Member who wishes to be heard or have their opening statement inserted in the record?

Mr. MANZULLO. I wish to have mine put into the record.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Manzullo's statement may be found in the appendix.]

Chairman LAFALCE. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. I appreciate your holding this hearing, one of several addressing the North American Free Trade Agreement. Trade is obviously a very important economic issue to our Nation, as well as to my State.

In 1991 alone, Georgia produced $377 million in exports to Mexico and $1.4 billion to Canada. Strong trade produces jobs and capital, which are both requirements for a healthy and growing economy. All things being equal, open free trade is a good idea that will certainly enhance the economic strengths of all involved.

Certainly the world market is now moving toward a more open idea of trade, and it is important that the United States be a part of such. However, as I have stated before, I have several concerns about NAFTA. Not all things are equal between Mexico and the United States. I believe those economic, labor, environmental, and political differences are reason for concern.

Low wages are not the only reasons companies will move to Mexico. The lack of incentives for investment in this country; EPA regulations; employee benefit packages are very costly, including health care and the threat of more participation by Government in health care; also an unemployed labor force that would be ideal for manufacturing jobs, but is trapped in the welfare system that we have in this country.

Mr. Chairman, I appreciate the opportunity to discuss the economic conditions of Mexico and possible impacts that the passage

or failure of NAFTA will have on our economy; and I look forward to the testimony.

Chairman LAFALCE. Gentlemen, we convened so that we could hear from your diverse backgrounds and your diverse points of view, so let's begin. We will put the entirety of each of your prepared remarks in the record as if they were read. Some of them were quite lengthy and we cannot have each of you present your entire statements verbally.

I ask you to summarize and, hopefully, within 5 to no more than 10 minutes. Having seven witnesses who want to have a dialog, we will have to try to do that. So please try to do it within 5 to 10 minutes if you can.

TESTIMONY OF JOHN WILLIAMSON, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Dr. WILLIAMSON. Mr. Chairman, I am delighted to be here this morning. I must say that I have spent a fair part of my professional career worrying about exchange rates and I am delighted to find that you share my concerns about the crucial importance of getting exchange rates right as a part of macroeconomic policy and a component of a free trade area. As a matter of fact, when discussion on——

Chairman LAFALCE. I think it is the most important part of any trade bill.

Dr. WILLIAMSON. I more or less agree. When the United States-Canada agreement first came up for discussion, I actually wrote an appendix in our first study from the Institute for International Economics on that topic. We did indeed urge that there be an agreement covering the monetary dimension as a part of that agreement. I regret to say that when my colleagues Gary Hufbauer and Jeffrey Schott came to work on the NAFTA, that either we lost the first battle and so perhaps we didn't try to raise the issue again or maybe I was diverted elsewhere, but anyway it slipped between the cracks and we didn't address the issue.

My own sympathies are with you in thinking it would be desirable to have a monetary dimension to a NAFTA agreement.

Chairman LAFALCE. You are a strong proponent of NAFTA, are you not?

Dr. WILLIAMSON. Yes.

I will summarize the remarks of my written testimony briefly. I start by remarking on the major reforms Mexico made and welcoming those and noting that in conjunction with the Brady plan debt settlement, they have led to an encouraging recovery in Mexico, although that has still not taken Mexico back to the sort of major growth that it had before the debt crisis.

I then suggested there were two major threats to that recovery continuing. One would be a rejection of NAFTA, with the effect that this would be likely to have on confidence in Mexico and the peso. The other is the size of the current account deficit that has now emerged, carrying a danger that if it is not brought under control in a managed way in good time, it could lead in due course to a forced maxidevaluation, perhaps bringing with it a collapse of the

stabilization program or perhaps concerns about competitive devaluation in the United States.

So I think it is important to try and head off that risk. In order to do that, one needs an estimate of the extent to which the peso is currently overvalued. I don't think there is much doubt that it is. The big question is by how much.

I go through some fairly conventional calculations noting the size of the current account deficit, 7 percent of GDP. I think that Mexico could afford to have a deficit of 3, maybe 3.5 percent of GDP. That comes out of both my own calculations and it is also the assumption of Hufbauer and Schott on which they based their calculation of employment gains to the United States as a result of NAFTA.

Chairman LaFalce. That was short term——

Dr. Williamson. It is medium term, a 5-year horizon.

I worry about this large deficit at the moment. The more recent figures which I have been receiving from various Mexican quarters since they learned about my testimony suggest that I was slightly on the pessimistic side, that exports in the first quarter of this year compared to the first quarter of last year, the latest figures suggest that exports grew 12.2 percent against imports 10.3 percent. Exports are therefore now once again going slightly faster, but not sufficiently faster to reduce the gap in absolute terms.

There has been no further real appreciation in the last year. Unit labor costs are still more competitive than they were before the debt crisis. So there are factors on the other side to my paper, but nevertheless I don't think it allays my concern that the peso is somewhat overvalued at the moment, and contrary to what Mr. Baker said, I think that one should worry about exchange rates. I don't think that they are an act of God. Certainly the Mexican peso is managed by the Mexican authorities. It now has a band within which it floats, but that band is very much a product of policy and I think it is legitimate to discuss it.

Using an estimate from another of my colleagues, William R. Cline, based on a trade model that he has built, I argue that the best guess as to how much the Mexican peso is currently overvalued is something around 10 percent. These figures are not particularly accurate, but that is the order of magnitude.

I make some allowance for projected improvement in the auto balance as a result of investment in progress and for the U.S. recession. These are factors that have to be introduced into such a calculation, but at the end of the day, I suggest 10 percent is as good a guess as any.

I then discuss the question of what should be done about it. At present the lower edge of the band as we would think of it, the exchange rate band as we would call it in Anglo-Saxon terminology - our Mexican friends think of it as the upper edge of the band - they turn the exchange rate upside down when they measure it, but let me——

Chairman LaFalce. That creates so much difficulty in comprehension.

Dr. Williamson. Yes, true. The low edge of the band as we think of it is currently depreciating at 4.6 percent a year and the top end is fixed so the band is getting wider. I think that is a sensible

policy, qualitatively. I worry that the rate of depreciation of the bottom edge of the band is still on the slow side.

At best it is going to prevent a further erosion in Mexican competitiveness. It is not going to regain competitiveness by 10 percent unless they have a lot more success in getting inflation down even further, while we may hope that they will have such success, I think there is a very real question as to whether that should be the overwhelming priority of Mexican policy at the present time.

There are two alternatives that one can discuss to get an improvement in competitiveness. One is to do a maxidevaluation before the market expects you to preempt the market. I don't think that that would be a wise policy, because if you preempt the market in time, the next time the market has suspicions it will preempt you [just like what happened to Spain and Portugal last week.] It becomes more difficult to hold a managed exchange rate the more often you try to take the market by surprise.

Those sorts of expectations prompt damaging speculation. I think there might also be a reaction in the trade union movement in Mexico, since exchange rate policy was part of the PACTO and if the government changes its side it seems to me that one would be lucky to have the trade unions acquiesce without objection.

So it seems to me that a maxidevaluation would be a dangerous tack to try and take. The alternative is to increase the rate of crawl. That was already done a little bit last September without adverse effects on financial confidence and the trade unions still went along with a renewal of the PACTO that reduced the rate of wage increase. So I think that precedent could be built on.

The sort of figure I suggest is maybe an acceleration in the rate of crawl to something like 10 percent a year, an extra 5 or 6 percent on the rate of crawl. That might take inflation up to 11 percent instead of down to 9 percent this year, but it would on the other hand allow competitiveness to increase by 3 or 4 percent a year rather than staying more or less flat, and that it seems to me would be enough to reassure the markets that Mexico has things under control.

I discuss the cost of this policy. First, would it force a further rise in interest rates? There is something like a 5.6 percent interest rate yield differential on peso assets at this time which results from the lack of confidence that Mexico can't avoid a maxidevaluation. If you attenuate those concerns maybe you can accelerate the rate of crawl without having to push up the interest rate, at least not very much.

Second, there would be some delay in getting inflation down. I think that is a pity. Inflation stabilization does matter, but it is not the only thing that matters and there is a trade-off with growth in the short run, and the short run isn't so short that one can dismiss those concerns.

It was announced earlier this week that the Banco de Mexico, the Central Bank of Mexico, is to be made independent. In principle I welcome an independent central bank. I am a little bit concerned, however, about the idea that the terms of reference of the independent Central Bank will be so narrow that it would be told to concentrate only on inflation stabilization. I think there ought to be some consideration for other objectives of the Government in

the way that the Bundesbank has to take other objectives into account and is not told to take account just of the rate of inflation. That seems to me to be the right formula. Maybe you can urge our Mexican friends to look at the German precedent and not go overboard on independence for the Bank of Mexico.

Finally, I think that there is hope for the United States to exert a constructive influence on Mexico by urging causes like an acceleration in the rate of crawl rather than a maxidevaluation. I would not take very seriously the fears of a sudden maxidevaluation after NAFTA has been signed in order to gain a competitive advantage certainly not if there is an independent Bank of Mexico. The greater danger is that the Mexicans may lose control of things if they are unreasonably rigid in their policies in the short term, and it is that danger which I hope that you may be able to help fend off.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you.

[Dr. Williamson's statement may be found in the appendix.]

Chairman LaFalce. Dr. Ramirez.

TESTIMONY OF ROGELIO RAMIREZ, PRESIDENT OF ECANAL, S.A., MEXICO CITY

Dr. Ramirez. Thank you, Mr. Chairman. I am delighted to present my testimony to this committee on the topic on which I have dedicated the last 10 years of my professional life. I follow up on a regular basis the developments in the Mexican macroeconomy and I interact with decisionmakers in the business community, decisionmakers who are involved in international business and investment decisions. So I hope that my contribution can shed some light on the course of exchange policy in Mexico and I am anxious to emphasize that monetary policy in Mexico, particularly exchange rate policy, needs to be distinguished as a short policy from the longer-term trade policy.

The longer-term trade policy has longer-term implications for the allocation of resources and for investment, whereas short-term monetary policy concentrated on the exchange rate is of a different nature. Therefore I don't see immediately a connection between the NAFTA negotiations and exchange rate management in Mexico.

Having said this, I would like to highlight that there is concern in the international investment community about the peso exchange rate. This concern can be justified on two grounds. First of all, there is a current account deficit which has reached very high proportions, reaching 7 percent of GDP in 1992.

Second, there is a very clear shift in relative prices over the last 5 years since December 1987, when the Pact of Economic Solidarity started in Mexico, very much centered on the management of the exchange rate. There has been considerable change in relative prices that appear to have hurt the profitability of exporters, and to have favored the importation of goods.

But I would like to separate the causes of the current account deficit and I have difficulty distinguishing which is the precise contribution of the exchange rates appreciation to the expansion in the current account deficit to be distinguished from the fall in the

rate of foreign domestic savings that has taken place in Mexico. Particularly in 1991 and 1992, the rate of private consumption in Mexico increased by 5.0 and 5.9 percent in each of these 2 years at a time when the gross domestic product was only increasing 3.6 and 2.6 percent.

In fact, the rate of growth of private consumption has an acceleration when the rate of growth of GDP suffered from deceleration. Much of this increase in private consumption has been boosted by very high growth in commercial bank credit to the private sector which on a compounded basis for the last 4 years has recorded 20 to 25 percent annual growth.

The allocation of this credit has in large measure gone to consumption although the increasing investment has also been remarkable. Therefore, the expansion of the current deficit has something to do with credit growth and with the rate of growth in private consumption and not only with the real exchange rate. The real exchange rate, however we want to measure it, has suffered a very substantial appreciation.

If we take consumer prices in Mexico and consumer prices in the United States, we see a very substantial appreciation between 1987 and 1992. If we take the rate of growth of wages in the manufacturing industry, we also see a very substantial appreciation which is not in the largest measure of it, justified by increases in Mexican productivity that are higher than those in the United States. That is, real wages in Mexico have recorded very high rates of growth and part of that I could say has also to do with the rapid expansion of credit.

But the strong exchange rate which we have seen in Mexico in the last 4 years has also acted as a substantial stimulus on increasing efficiency in the manufacturing industry. There has been considerable restructuring in Mexico in the manufacturing industry owing to the appreciation of the real exchange rate and this is partly reflected in the fact that some industries, manufacturing industries record relatively high growth; for example the auto industry, chemicals, some electronics, office equipment, but other industries are recording either nil or very weak growth such as textiles, footwear, paper, wood, and some metals.

So that on the whole manufacturing employment has only recorded a 3.3 percent increase from the year 1987 to 1991 and in the year 1992 it recorded a fall of 3.7 percent over the previous year. So that the exchange rate, the strength of the exchange rate which has helped so much to reduce inflation from 15.9 percent in December 1987 to 11.9 percent in December 1992, has also had an effect on slowly growing industrial output and negative employment in the manufacturing industry.

There is very limited scope for exchange rate changes in Mexico for three reasons. The first one is that in our experience in Mexico for the last 20 years, we realize that in exchange rate policy, confidence is about everything. There is very limited scope for very large movements in the real exchange rate if the Mexican Government wanted to induce these changes as has been mentioned, trying to anticipate the market or trying to play smart to the market as confidence would be hurt.

The second reason why there is limited scope is that we have in place a social pact which was implemented in 1987 and has until now been successful in reducing inflation and distributing social costs among different sectors.

One of the sectors that has been vastly affected by this policy as I mentioned earlier is exporters, manufacturing industry, which has seen profitability being squeezed substantially over the last 4 years, and yet some of these industries continue to invest and to expand because they see the longer-term gains of an inflation environment which is consistent with that of our major international partners.

In the light of this limited scope, I can only see the current deficit of Mexico continuing to expand by the reason that the Mexican market has a propensity to grow, a propensity to consume and a propensity to import far higher than that of the United States.

The third reason for the limited scope of exchange rate changes is that there is a great deal of reputation on government policy to be lost if there are changes that the market does not anticipate in exchange rate policy. So what to do about this strengthening of the peso?

The first question is why do we have to think that we have to do something? What would be the objective for changing exchange rate policy? I can see two possibly conflicting objectives in the short term. One is competitiveness for industrial producers and the second is inflation.

Mexico has had a very bad experience with devaluations. To illustrate the point, between 1982 and 1987, the Mexican peso devalued from about 25 pesos to the dollar to about 2,200 pesos to the dollar, and we did not gain competitiveness.

By the end of 1987, the Mexican peso was estimated to have been under valued at only 34 percent.

Chairman LaFalce. Doctor, I don't want to interrupt you, but I am hoping that you could summarize your remarks.

Dr. Ramirez. I am going to go to the policy issues.

If it took a 100 times fold increasing the nominal exchange rate to gain only 34 percent on under-evaluation of the exchange rate, I think the question of using the exchange rate to gain competitiveness in Mexico is not very high on the agenda.

I would therefore suggest that the best policy for Mexico would now be to use the present band already in place, that allows for devaluation for the next year of about 9 percent without losing the reputation and without giving any surprises to the market.

I would further propose that for trade policy the exchange rate issue is not a useful one to look at the moment. As the experience of European countries demonstrates, exchange rate bands become in the end corsets that prevent the operation of an efficient monetary policy.

Thank you, Mr. Chairman.

[Dr. Ramirez' statement may be found in the appendix.]

Chairman LaFalce. Doctor Salinas-Leon.

TESTIMONY OF ROBERTO SALINAS-LEON, EXECUTIVE DIRECTOR, CENTER FOR FREE ENTERPRISE RESEARCH

Dr. SALINAS-LEON. Mr. Chairman and members of the committee, I appreciate the opportunity to testify before you today on the topic of North American Free Trade and exchange rates stability in Mexico.

My name is Roberto Salinas-Leon, no relation to our current president. I am a Mexican scholar who shares the growing awareness among my fellow citizens that forging of closer commercial link with the United States under the North American Free Trade Agreement constitutes a crucial mechanism to consolidate the economic course of stable and sustained growth brought about through the wave of market-oriented reform which has characterized my country's progress during the last 5 years.

The timeliness of these hearings on the future of the peso-dollar parity and its impact in the development of U.S. imports and investment in Mexico could not be more exact, but the reason for this transcends the latter concern.

Mr. Chairman, 3 days ago a presidential initiative was issued decreeing the independence of monetary policy from the government. This dramatic announcement implies the full autonomy of the Banco de Mexico with respect to the management of inflation targets, exchange-rate stability, interest rates, and other important items of monetary policy.

So far, this reform has been received as a reliable institutional guarantee of long-term price stability and long-term health in public finances. By formally serving the government's financial needs for cash from the role of the central bank of strengthening the purchasing power of our currency, the Salinas administration has established the irreversibility of fiscal discipline and balanced budgets. Thus, the government will no longer be able to rely on quick financing of populist programs as it did in the seventies and eighties, something which brought about our exchange rate crisis in those times, via the inflationary course of monetary expansionism. In this way, price and exchange-rate stability become has become virtually institutionalized.

NAFTA is also considered another strategic tool to cement the changes fashioned in the wake of responsible fiscal policy, large-scale privatization of inefficient State-run enterprises and aggressive trade liberalization. Notwithstanding the immense benefits of three-way free trade in North America, the agreement has been the object of much emotional criticism on the part of labor and environmental organizations in the United States.

The vast majority of the special interests onslaught has been exclusively extra-commercial, from fear of the mass job displacement in the United States to Mexico's political credibility, and even issues of cultural identities. The newest concern of a sharp devaluation of the peso vis-a-vis the dollar following the implementation of NAFTA fits this unfortunate category.

Nevertheless there are several overwhelming arguments against the desirability of a devaluation to boost Mexican exports and inhibit U.S. imports. It is not the implementation of NAFTA that makes a difference with respect to the peso's stability, but just the

opposite. In the absence of NAFTA, economic expectations would plummet and with it Mexico's opportunity to adequately service the financial needs of a required expansion in its private sector current account deficit.

In short, Mr. Chairman and members of the committee, if you vote against NAFTA, you are directly contributing to a potential and crushing devaluation in Mexico. The Mexico-based companies you all represent, together with the jobs they sustain, would find their position seriously jeopardized.

Trying to put this in context, I would like to add the series of strides that have been taken in fiscal discipline and stabilization because we cannot understand the role that exchange rate stability plays in Mexico today unless we know a little bit about what has been done in the last 5 years in terms of a program of fiscal discipline.

The Federal budget deficit, the public sector deficit has been reduced in a dramatically from 17 percent deficit of gross domestic product to a surplus this year of 1.7 percent.

Chairman LAFALCE. Dr. Salinas-Leon, up until now you were reading from your text. Have you gone to another portion of your text?

Dr. SALINAS-LEON. No. I am expanding on the introductory remarks.

In 1987, we had 17 percent public sector deficit of gross domestic product. This has been turned into a budget surplus excluding revenues obtained from large-scale privatization. This year we are estimated to have a budget surplus of 1.7 percent of GDP. With this, inflation has fallen from 15.9 percent in 1987 to around 10.1 percent as the latest annualized estimate.

It is an all-important concern in Mexico, contrary to the suggestion of Dr. Williamson, to fight against inflation in view that only 5 years ago we had triple-digit inflation and were on the verge of a hyperinflationary crisis.

Debt amortization has followed in the wake of fiscal discipline and the efforts to stabilize the currency as well as the economy in general. About a week ago, 10 [10] percent of internal debt was retired. In an announcement made yesterday, our Finance Secretariat claims that reserves today which stand around $20 billion are larger in amount than the money in circulation. If this is true, even if there was a complete drop in economic expectations, Mexico could adequately sustain its exchange rate.

I share the opinion of Dr. Ramirez that a devaluation will not make Mexican exports more competitive. In view of the fact that it places pressure in stabilizing economic expectations, a maxidevaluation would almost surely result in a crushing blow to expectations with a complete loss of confidence in Mexico and this would wipeout any competitiveness gained in a 6-month interim, quickly withered away by a resurgence of the inflationary spiral and by the loss of confidence, a drop in investments, contraction of growth and more.

A recent economic analysis by the largest bank claims that possibly the only sectors among 20 that would benefit from an exchange rate adjustment would be transportation, among others. Productivi-

ty seems far more a factor to competitiveness in Mexico than does the exchange rate.

The current account deficit which is obviously a topic of concern, I also share Dr. Ramirez' finding that even independently of exchange rate considerations we are going to see an expansion in the current account deficit as a result of massive deregulation.

I think that if we consider the conditions of whether devaluation will occur in Mexico at least three factors would have to occur. First, a contraction in investment flows. They would have to be going down; yet today they are going up, suggesting that antidevaluation conditions are being implemented in Mexico. Reserves would have a downward turn and yet today we have our highest reserves in history.

Inflation would have to be going up and yet inflation is the lowest it has been in 22 years.

My conclusion, Mr. Chairman, is that the Mexican Government today, rhetorically speaking, would probably be more willing to sell off its oil concerns, perhaps even the pyramids, instead of recurring to the strategic disaster of a devaluation.

For this reason, I urge you and your colleagues to vote a vote of confidence for Mexico in terms of voting for NAFTA, for this is one crucial institutional mechanism whereby we can obtain the investment flows that an undercapitalized economy like Mexico needs.

Chairman LaFalce. Thank you.

[Dr. Salinas-Leon' statement may be found in the appendix.]

Chairman LaFalce. Our next witness is Carlos Heredia.

TESTIMONY OF CARLOS HEREDIA, DIRECTOR, INTERNATIONAL PROGRAMS, EQUIPO PUEBLO AND VISITING FELLOW, THE DEVELOPMENT GAP

Mr. Heredia. Thank you, Mr. Chairman and Members of the committee. I am glad that you called this hearing on the possible devaluation of the Mexican peso and its impact on NAFTA.

Chairman LaFalce. Some people criticized me for pursuing this, but I think this is in the best interest of the Mexican people and of the United States people. Some people have suggested that perhaps the recent actions in Mexico purporting to establish some independence for the Bank of Mexico could have been caused, at least in part, by anticipation of these hearings.

Mr. Heredia. May I suggest that. I was going to say, every time there is a hearing in the U.S. Congress on some touchy issue in Mexican politics, or the Mexican economy, we hear big announcements.

We heard a refinery was going to be shut down, a national human rights commission was going to be created. We hear the central bank will be independent. I hope the Government will live up to its promises. If you have a hearing in the next couple of months, probably we will hear that we will have clean elections in 1994.

Chairman LaFalce. We want to stay off that issue.

Mr. Heredia. I want to concentrate today, Mr. Chairman, on the impact of the current monetary and fiscal policies and liberalization policies on the Mexican people. I want to discuss policy and

the impact on real people. I want to say what is happening in the Mexican countryside with small farmers and what is happening to Mexican small business with the current policies.

I am not here to advocate a devaluation or to speak against a devaluation. We definitely need policies that are sustainable vis-a-vis the exchange rate, vis-a-vis trade, vis-a-vis national life. What is happening to small businesses and to consumers?

In a period when we supposedly have healthy growth of the economy, nonperforming loans in Mexico are going through the roof. Such loans used to account for no more than 3 to 4 percent of a portfolio of a bank. But now they are in excess of 8 percent for the whole of the system. Mexican middle-class consumers are facing enormous difficulties in paying their mortgages and their car loans. Servicing their debt becomes too heavy a burden, so many are ultimately forced to give up their assets.

The overwhelming majority of productive establishments are fighting to survive. Even some of the big firms, publicly owned firms whose stock is traded on the Bolsa, incurred losses in the first quarter of 1993. These firms have access to external financing in dollars at 8 to 10 percent interest rates instead of the rates of 35 percent up available in pesos to smaller companies.

Take now the unemployment figures: According to the official data, the unemployment rate in January in Mexico was only 3.5 percent of the work force, as opposed to 7 percent in the United States and 11 percent in Canada. This figure is one that not even those who compile these statistics believe. In the case of small business, the combination of sky-high real interest rates, fiscal terrorism, and the absence of the rule of law have created a hostile environment that is forcing them to close shop. As a result, the current level of employment in the manufacturing sector is still under the 1988 level when the Salinas administration was inaugurated and well below the 1980 level.

What is happening to small family farms? There has been a drastic reduction of credit for production of basic grains and for regions considered to be less productive. In the last 10 years, the number of producers receiving development bank credit fell from 2.5 million to half a million. This plight that the Mexican peasants are going through is better illustrated by a recent initiative of a peasant federation in the State of Chihuahua, who are planning a massive walk and border crossing to the United States, in what has been labeled "NAFTA Exodus, the first wave" to again call attention to their urgent need for debt relief and accessible credit.

NAFTA in its current form will continue to favor corporations and banks over the needs of small producers, farm workers, and poor communities, so the northward migration would only intensify. Let's remember that in 1992, after a decade of trickle-down economics, the migration of Mexican workers to the United States reached a record high.

Let me now go to the question, Mr. Chairman, that you have put before us on the need for an exchange rate understanding in the NAFTA. I am a member of the Mexican Action Network on Free Trade, and our Canadian colleagues tell us that despite the fact that it was not built into the United States-Canada Free Trade Agreement, we did see - in the 4 years following the outset of the

negotiations—the Canadian dollar raising from 71 cents to the U.S. dollar to 89 cents to the U.S. dollar. We saw cross-border transactions between the United States and Canada favoring, to a good extent, retailers on this side of the border.

We would like to know to what extent——

Chairman LaFalce. That has changed dramatically in the past year.

Mr. Heredia. I know. I was referring up until 1990.

Although the Canadian dollar now has gone down, we would like to know whether in the current NAFTA there is some sort of an understanding between the Governments of Mexico and the United States in this regard; and any such commitment should be disclosed.

Can a devaluation in Mexico be avoided? It seems to me that in the medium run adevaluation is inevitable since a level of current account deficit of 7 to 8 percent of GDP is not sustainable. The Mexican Government does not want to devalue, and we are being told that if NAFTA is not ratified, chaos will just erupt. Investors will divest from the Bolsa, there would be massive capital flight to the United States, and financial collapse will once again raise the question of whether the United States Treasury should rescue the Mexican regime and should bail out the Government of Mexico again.

My point is, what is the case of bailing out an economic program that has failed to meet the interests of its people and thus can promote little economic and social stability. Massive amounts of financing have been injected into Mexico over the past 3 years, but little real development has been engendered. We are talking about not so much a problem of financing as one of policy. It would be far better for the Mexican people if we were to address the question of the country's underlying economic strategy.

With or without a NAFTA, economic policy in Mexico is approaching a dead end because that model relies on heavy capital inflows from abroad and results in a steep concentration of income and wealth and is hardly a good basis for medium- or long-term stability.

Mexico, Mr. Chairman, has had trade liberalization, but it can hardly be said that it has had export-led growth; in fact, what we have had is import-led, insufficient growth.

A sustainable economic and trade strategy for the long term is not feasible without three vital elements: A competitive exchange rate, an industrial policy that designates areas of priority and allocates resources accordingly, and import controls such as quotas and tariffs to protect the strategic sectors. Of course, this is a sin at a time we are discussing economic liberalization and trade liberalization, but even World Bank research has proved that in Southeast Asia Governments have succeeded in intervening successfully with these kind of policies more often than it is acknowledged by free-traders.

It is essential that in Mexico we finish with a kind of "market dictatorship" by which wages are suppressed and by which the purchasing power of the people is also suppressed. People are increasingly unable to buy the goods they produce.

A little more growth in exchange for an increase of 2 or 3 points in the inflation rate would not be out of place. This overall strategy would stimulate production, discourage speculation, and reduce exchange rate volatility. In addition, it would do far more in the long run than would NAFTA to save American taxpayers the cost of having to prop up and bail out the Mexican regime once again.

Thank you.

Chairman LAFALCE. Thank you.

[Mr. Heredia's statement may be found in the appendix.]

Chairman LAFALCE. Our next witness will be a very distinguished Professor of Economics from the Massachusetts Institute of Technology who has written very, very extensively on these areas, Dr. Dornbusch.

TESTIMONY OF RUDIGER DORNBUSCH, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. DORNBUSCH. Thank you, Mr. Chairman. I welcome the opportunity to share with you and the committee my views on the Mexican peso and how Mexico can serve us to get an expansion in jobs with the President's program.

Dr. Williamson said much of what I was going to say except for his conclusions, so I will try to be brief.

My first point is that the Mexican peso is overvalued, there is little doubt. There may be doubt about the size of overvaluation but not about the fact. I show in my testimony on page 4a both a measure of the real exchange rate of Mexico - and of course it is important to adjust the peso for diverging inflation trends here and there, and I see a substantial real appreciation of some 40 percent over the last few years - and I show the trade balance that has shifted into a very substantial deficit.

Why is the deficit so large? Four explanations: Low oil prices, higher Mexican growth, trade liberalization in Mexico, and real appreciation of the currency. Each gets a share.

What can you do about it? About oil prices, Mexico can do nothing. About growth, they should do nothing. Trade liberalization, I hope they won't do anything. That leaves the peso as the active variable.

What can be done about the peso and the current account? One possibility is to ignore the problem, and the problem then emerges in the form of high interest rates that slow down Mexican growth and precarious financing of a very large current-account deficit, increasing the very short-horizon money where anything that happens here has a major repercussion on the interest rates——

Chairman LAFALCE. You characterize this in your testimony as the sit-tight-don't-blink policy?

Dr. DORNBUSCH. Yes. That runs the risk of one morning the financing not being there, and then overnight a catastrophe in the foreign exchange rate market in growth, in the labor market in real wages. I think that is an extremely undesirable strategy.

Chairman LAFALCE. Before you go to the second strategy——

Dr. DORNBUSCH. On your time, Mr. Chairman.

Chairman LAFALCE. Surely. As part of your first strategy, you said there is a powerful line of argument that seeks to underpin

the do-nothing strategy by institutional mechanisms, specifically the creation of a independent central bank.

What did you mean by that, because that is what they are striving to create, an independent central bank. I didn't know what conclusion you wanted us to draw from that.

Dr. DORNBUSCH. The attempt is to say that increasingly Mexico finds mechanisms of financial stability that would reinsure investors and therefore continue up the financing of the deficit while nothing else is done. An independent central bank is one of the symbolisms that is being used to support the financing of large deficits, conveying an impression of financial solidity, of progress in the direction of moderate inflation.

I will return to the issue in a moment.

So doing nothing other than small institutional arrangements without significant impact on the external balance, I think is an undesirable strategy.

Second, big devaluation, I think is far worse. That would raise serious questions of what comes next in labor relations, in wage settlements; and any foreign investor that does not know what will happen will not come back to Mexico. If the financing goes away, then an 1982- or 1986-style crisis would be there immediately - not in Mexico's or in our interests.

Third, is a more rapid pace of devaluation of the peso that Dr. Williamson advocated. I think that is a good strategy, except that it means in the end there is more inflation, not less inflation. I don't believe inflation at the Mexican level is deadly and that growth is important. That is a seductive and reasonable strategy that I have advocated over the last half-year.

The fourth option being pursued in Mexico may be preferable, drastic disinflation. Since last December, with the new pact in Mexico, inflation has been brought down to 7.5 percent in the most recent data, and there is perhaps an expectation of another PACTO coming that would take it to an annual rate of 2 to 3 percent by late this year. That would mean the ongoing overvaluation would be stopped, but there would be nothing to reverse the overvaluation that has built up over the last 3 or 4 years.

One can interpret the independent central bank as an extra effort to reinforce this disinflation strategy, something that is new and something that is now showing results. I believe in the end that for Mexico, where inflation is an important social issue with very identifiable consequences for the poorer part of the population, that the choice of rapid disinflation rather than a bit more rapid depreciation, a bit more rapid crawl, is the preferable strategy; and I therefore support that direction of policy.

Let me conclude by asking, what is the U.S. interest in this; and second, the question that you raised in your introductory remarks, should there be a side agreement on exchange rates?

The U.S. interest, of course, is in having jobs and having profits for small business and even for large business from our trade with Mexico. The last 5 years have demonstrated that an open Mexico is an unusually profitable source for jobs and for business. We have had a shift in our trade balance with Mexico of $9 billion. If one reckons $30,000 to the job, we will have created a net 320,000 extra jobs from modernization, from trade liberalization, and from real

appreciation in Mexico; and that is net and that is good and wonderful and NAFTA certainly would do more of the same.

I do not believe the analysis proposed by Ross Perot in "Jobs at Risk." I think that is shoddy, not serious, and does not add anything profitable to this debate. NAFTA, for us, creates jobs, but only if we have a stable Mexico. Here, I want to come to the issue of having an exchange rate agreement as a side agreement to NAFTA.

We have to ask, what do we want? An overvalued currency in Mexico is wonderful because a country falls over our goods because they are cheap. But an overvalued currency has to be defended by very high interest rates that translates first into very low growth and ultimately into financial instability. A very undervalued peso, on the contrary is terrible because Mexico is supercompetitive, but there is the other side that the undervaluation of the peso gives us a high standard of living and gives Mexico high rates of growth, which translates into increased imports in the end and benefits for us. We have to go for the middle of the road, with reasonable interest rates, where every year they grow and where we have none of the extremes.

Can we make an agreement that avoids the extremes on both sides? I believe that is very hard to put in writing. Mexico continues to be an oil exporting country. Certainly if oil went to $5 a barrel, Mexico would have to have a devaluation just to pay its bills. If oil went through the roof, Mexico could afford a far better exchange rate.

Mexico is converging on the United States over the next 50 years, and I think it is very hard to put on an exchange rate number that is reasonable. Our best hope is in stable Mexican policies and to avoid the extreme fluctuations of the past that have apparent benefits for us when they are overvalued and apparent losses when they are undervalued, but the instant hurts. We can trust that they have a great interest in driving in the middle of the road, and that ultimately produces for us the benefits of jobs.

I conclude by saying that the exchange - rate issue in the context of Mexico is perhaps not something that we should worry too much about; stirring up trouble makes the issue more lively and perhaps prejudices the financing while NAFTA is being negotiated.

It would be wonderful if your committee chose to hold hearings on Asian currencies that are systematically undervalued for well over a decade, much to the detriment of such jobs.

[Dr. Dornbusch's statement may be found in the appendix.]

Chairman LaFalce. We are having such a hearing next Wednesday.

I point out, Dr. Dornbusch, that my suggestion was not to come up with an agreement which specifies a given peso to a dollar, but to create a consultative mechanism, a coordinative mechanism and perhaps a corrective mechanism as the EC community has done, not exactly——

Dr. Dornbusch. Hopefully not the same because it is deadly.

Chairman LaFalce. Something was suggested in the appendix to the Canadian FTA by Dr. Williamson, something similar to what I put in the 1988 law with respect to the G-7 countries.

Doctor Levinson?

TESTIMONY OF JEROME I. LEVINSON, VISITING FELLOW, ECONOMIC POLICY INSTITUTE

Dr. LEVINSON. Thank you, Mr. Chairman.

Given the extensive discussion you have heard from the others, I will simply try and base my remarks off of their remarks. It seems to me that what you have is a seamless web between an overvalued peso, the current account deficit, the financing of the deficit and Mexican and United States politics.

If I understood Dr. Salinas-Leon correctly, at one point in his statement he said that failure to approve the NAFTA would be the surest way to plunge Mexico into a major devaluation. So, inevitably, what seems to be a technical question leads back into the basic political and economic context of issues, which is summed up in the NAFTA.

The numbers it seems to me tell the story. Mexico is now running a current account deficit of approximately $24 billion. According to the Council on Foreign Relations' spring report, last year Mexico had an inflow of $18 billion of which $5 billion was foreign direct investment. The remainder, $13 billion, was capital either moving into portfolio investment or seeking higher interest rate returns.

I think Dr. Dornbusch referred to that if he didn't use the phrase hot money or at least volatile money, as money extremely susceptible to perceptions. We had a dramatic illustration of that volatility last week when Mr. Panetta indicated he thought NAFTA was in difficulty in the Congress; the Mexican stock market plunged 30 percent before noon and only recovered after other administration officials intervened to say that they did not share that assessment, which I think is illustrative of the volatility of this strategy that is so heavily dependent on financing this current account deficit by these external flows, primarily from the United States and composed in such large measure of this highly volatile capital.

I suggest that Mexico has trapped itself and the U.S. Congress. I couldn't have put it more bluntly than Dr. Salinas-Leon. In effect, he says that your political decision as to whether NAFTA is good or bad for the United States is constrained by the perception that if NAFTA will not pass in the Congress, that perception will create the kind of financial crisis that others have referred to here and that is on everybody's mind as to weather the peso is overvalued. That is the fundamental issue, the strategy which places such great reliance to finance this current account deficit upon this flow of capital from the United States, which is disproportionately coupled with capital of a volatile nature.

What I want to suggest to you is that as you consider the peso, the NAFTA and the politics of the matter, that the obligation is to consider whether this agreement is good or bad for the American worker. This inevitably leads back to the supplemental agreements which are being negotiated by Mr. Kantor and whether those agreements are going to have real substance. In my opinion, real substance on the labor issue means whether or not they will lead to Mexico allowing the formation of truly independent trade unions and constitute a chill on the abusive labor practices which have characterized the Mexican strategy.

We have heard with respect to the PACTO that the trade unions have accepted it. Well, there is a question as to what trade unions and the character of the trade unions and whether or not they are really free agents.

In effect your discussion, your opening up the question of the peso, leads you into a series of connected relationships; the current account deficit, which is a consequence of the policy of import liberalization et cetera, and the other factors mentioned, the financing of the deficit which relies so heavily upon capital inflows from the United States, of which a disproportionate amount is volatile, and therefore if you take a political decision which imperils that capital inflow you, the Congress throw Mexico into a financial crisis. But the real culprits are the ones who have led Mexico to believe that they could follow a low-wage/labor repression strategy which is the heart of the Salinas Government's PACTO and labor policy and, at the same time, have unrestricted access to the American market.

That is the reason that President Clinton in his Raleigh speech refused to go along with the Bush NAFTA Agreement without addressing labor and environment issues. That is at the heart of what Mr. Kantor is negotiating. I suggest that the question of the peso and the potential run on the peso should not distract you and your colleagues from the central issue of whether or not what Mr. Kantor is negotiating is a really effective agreement that addresses the underlying issue of the ability of Mexican workers to defend their own interests and obtain a proportionate share of the productivity increases which hopefully will result from increased Mexican growth.

Thank you.

[Dr. Levinson's statement may be found in the appendix.]

Chairman LaFalce. Based upon my experience from when I became interested in this, 1983 to 1985 when we saw the unbelievably strong dollar especially vis-a-vis the yen and since then, I won't worry about Members of Congress being so concerned about exchange rates that they lose site of everything else.

Dr. Levinson. I am not suggesting that they are going to be worrying about exchange rates.

Chairman LaFalce. This is a perfect cure for insomnia for many Members.

Dr. Levinson. What we are seeing——

Mr. Bilbray. I am concerned.

A few years ago when there was 12 pesos to the dollar, I left Mexico and kept $200 worth of pesos and I am bitter about that and concerned about the whole situation.

Dr. Levinson. This is an esoteric subject, but I think you saw in Sunday's Washington Post, the beginnings of the argument that if the Congress doesn't vote the NAFTA, there will be an inevitable financial crisis in Mexico, general chaos, et cetera. It is that I am trying to caution, that that concern about a run on the peso and the attempt to place the responsibility on the Congress rather than on the architects of the policy shouldn't divert you from the question of whether or not you are going to be faced with a good or a bad supplemental agreement.

Chairman LaFalce. Thank you very much, Doctor.

Our next and final witness is Dr. Gregory Woodhead.

TESTIMONY OF GREGORY WOODHEAD, ECONOMIST, TRADE TASK FORCE, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Dr. WOODHEAD. Thank you, Mr. Chairman and members of the committee for the opportunity to present the views of the AFL-CIO on the impact of a devaluation of the Mexico peso.

The chairman is to be commended for his recent article in Roll Call in which he expressed real concern for the dramatic and stark differences between Mexico and the United States approaches to democracy, human rights and justice in the workplace. The AFL-CIO shares those concerns and believes that the proposed NAFTA, if implemented, would do little to improve those conditions, while putting at risk the jobs and incomes of millions of U.S. workers.

The recent history of Mexican exchange rate policy, together with present economic pressure, suggests that devaluation is inevitable. The focus of this testimony is on identifying the winners and losers following a peso devaluation. The first effects will be on the U.S. business community.

Effect first, export slowdown. As a consequence of a peso devaluation the price of U.S. made products purchased with pesos will rise and therefore slow down U.S. exports to Mexico. The current surge in exports to Mexico will come to a halt and the balance of trade with Mexico will return to the historic pattern of trade deficit.

[The chart may be found in the appendix.]

Dr. WOODHEAD. The second effect is on production costs. A peso devaluation will reduce the cost of producing in Mexico relative to producing in the United States. Purchases of land, manufacturing plants and equipment which are denominated in pesos will be cheaper after devaluation. The key factor of labor costs will decrease relative to labor costs in the United States.

At a more realistic exchange rate, the Mexican real hourly compensation for production workers in manufacturing would be only about one-tenth the United States. For maquiladora employers, the $60 average weekly cost to employ a Mexican worker would be reduced to only $48. The decrease in overall cost of producing in Mexico will only provide added incentive for U.S. multinational corporations to relocate their manufacturing operations south of the border.

In addition, the lower costs for firms that relocate to Mexico place firms who cannot or choose not to relocate at a competitive disadvantage. Small business will be particularly hard hit. I would like to reiterate that small business will not be able to have the same option as a large multinational corporation. The peso devaluation will provide added rewards to multinational corporations that pursue a low-wage, run-away from labor and environmental standards strategy.

The second and more important series of effects from my perspective are the effects on U.S. workers. The first effect is in the export industries. Following a peso devaluation, a slowdown in exports to Mexico will eliminate thousands of jobs in U.S. export industries. The second effect is on factory relocation. A growing number of international economists recognize NAFTA as a trade

and investment arrangement that will only exacerbate the movement of U.S. factories to Mexico. The Bush negotiated agreement will lock into legal status a business climate in Mexico that will reduce the risk for U.S. investors who move south of the border. Over the long term, the increase in direct foreign investment in Mexico geared to export to the lucrative market in the United States will cost an estimated 550,000 jobs in the United States, primarily in manufacturing industries.

The devaluation of the peso will be the straw that breaks the camel's back as it will only add to the economic justification for firms relocating to Mexico. For U.S. workers, especially in manufacturing industries, devaluation can only mean the loss of more jobs. Following a crisis of 1982, the dramatic devaluations of the peso contributed directly to the surge in foreign investment in Mexico which resulted in the maquiladora program. This "free trade" zone along the Mexican side of the border now consists of approximately 2,100 factories employing 525,000 workers whose jobs used to be in the United States. Combining "free trade" agreements and currency realignment will produce a double-whammy for U.S. workers.

The third effect is on dislocated workers. For the U.S. worker whose job moves to Mexico, it is unlikely that he or she will find employment opportunities that pay wages and benefits anywhere near the level paid by the job lost. Manufacturing workers who lose their jobs to Mexico, especially those with years of seniority, will inevitably encounter severe economic hardship and reduction in the standard of living for their families.

For the 45- to 55-year-old worker who has only held a job in manufacturing, trade-related job dislocation is a devastating life experience. Even when a trade-dislocated worker manages to qualify for Trade Adjustment Assistance, completes a training program, and is fortunate enough to find employment in an economy that is not adding jobs, experience shows that wages and benefits will be reduced by approximately 50 percent in the new job.

Retraining from a manufacturing job paying $17.50 per hour with full benefits for an unspecified service sector job paying $11.75 per hour with very few benefits should not be considered progress. Although the AFL-CIO supports efforts to strengthen and increase funding for the Trade Adjustment Assistance Program, the primary emphasis of U.S. economic policy should be on measures to keep jobs here in the U.S. trade-related economic restructuring that lowers wages has produced a devastating effect on local, State, and Federal tax revenues.

More alarming is the under-consumption effect, where in overall demand for goods and services in the United States is depressed because workers are not being paid enough to purchase the products they are making. The high-skill, high-wage workplace envisioned by Secretary of Labor, Robert Reich, is incompatible with the low-wage strategy of United States multinationals. As a Nation, we must make a conscious decision about which way we are going to proceed, and Congress must enact policies to move in the right direction.

The next effect is the wage effect. The more devastating effect—one that will impact on the majority of U.S. workers—is that peso

devaluation, which reduces wages in Mexico relative to wages in the United States will put additional downward pressure on U.S. wages.

NAFTA will reduce the wages of about 20,000 for the 70 percent of U.S. workers who are not in high-skill, high-technology jobs by approximately $1,000 per year. The relative cheapening of Mexican labor through a peso devaluation will only hasten the decline in real wages in U.S. manufacturing. The downward pressure on wages is especially true in collective bargaining where the company's threat of moving to Mexico must be viewed as real by union negotiators faced with concessionary demands.

Finally, Carlos already addressed the issue of effects on Mexico. First, is the effects on Mexican exports. The business community, especially export industries eagerly await the positive impact of upcoming devaluation of the peso. The lower relative cost of labor will place manufacturers located in Mexico in a more competitive position vis-a-vis the United States manufacturer. Once the increase in direct foreign investment in Mexico has established a comprehensive export platform to the U.S. market, a lowering of relative labor costs through peso devaluation will only increase the flow of Mexican exports to the United States.

Second, it is clear that the cost of peso devaluation will be borne mostly by Mexican workers. Mexico has one of the most distorted levels of income in equality in the world.

The top 10 percent of Mexican workers make as much as the bottom 70 percent. Mexico has a poverty rate of approximately 40 percent, and an effective unemployment rate of around 20 percent. Out of a work force of 24 million people, two-thirds of the workers make less than $10 a day—when the cost of basic subsistence for a typical family of 5 is now approximately $16 a day. In other words, the majority of Mexican workers fortunate enough to have jobs make far less than what is required to support a family with basic needs.

The devaluation of the peso will place an uneven burden on the majority of low-paid Mexican workers. A devalued peso will increase the price of products made in the United States beyond the reach of millions of Mexican consumers.

In conclusion, the question of currency devaluation must be examined in light of both political and economic factors. NAFTA represents a never-before-tried, high-risk experiment in which two countries at far different stages of economic development and democratic rights are attempting to merge their economies. The danger in further peso devaluation lies in the inherent downward pressure on wages workers in both countries and additional incentives for U.S. companies to relocate to Mexico.

In sum, the combination of peso devaluation and NAFTA will be detrimental to the interests of workers on both sides of the border.

Thank you.

Chairman LaFalce. Thank you very much, Dr. Woodhead.

[Dr. Woodhead's statement may be found in the appendix.]

Chairman LaFalce. I think all of you have given excellent testimony. You surely present every perspective on the issue that can be presented.

Let me ask a few questions. Since NAFTA was proposed some years ago, there have been a number of studies regarding net gains, net losses, some losses, some gains, et cetera.

To the extent that you are knowledgeable about these various studies, to what extent did they assume absolute price exchange rate stability or do they factor in at all the prospect of devaluation either at the present rate or some other type of devaluation, and shouldn't they?

Who wants to - Dr. Williamson? Take the institute study——

Dr. WILLIAMSON. I can comment on that one at least. The way in which they approach it is by discussing what the current account deficit of Mexico is likely to be and then translating that into a bilateral surplus of the United States with Mexico. So implicit in that you might say is some assumption about the real exchange rate.

Chairman LAFALCE. What is that implicit assumption?

Dr. WILLIAMSON. Well, it is only implicit, so I don't know what it is. I think it would come out something like what I argued for. When I came to compare my analysis with theirs I found my assumption was essentially the same as theirs so therefore I presume that the implicit exchange rate in their analysis is somewhat similar to what I had, which is 10 percent less than it currently is.

Dr. LEVINSON. If you read the Hufbauer and Schott study, they don't explicitly address the issue you raise. Their estimate, 132,000 net job creation is based upon the assumption——

Chairman LAFALCE. Over a 15-year period.

Dr. LEVINSON. In their more recent study, they left out a table showing that over a 20-year period it equalized and maybe is negative. If you read their study, they say that the underlying assumption is that Mexico will follow optimum macroeconomic policies.

Without defining exactly what that means, I think they say it in two to four places, the assumption is that Mexico will follow macroeconomic policies which are positive and sound. The question is of course whether a $23 billion current account deficit with interest rates of 17 percent to attract this capital, is that the kind of macroeconomics assumption that they are assuming?

As Professor Dornbusch pointed out, the maintenance of that kind of interest rate climate is incompatible with the growth that they also postulate which is going to lead to American exports and jobs. So I think you have to be cautious about the studies and look at what the underlying——

Chairman LAFALCE. Believe me I don't put much credibility in any of these studies.

Dr. LEVINSON. Hufbauer and Schott destroy all the other studies and say that the assumptions are all misguided and that they therefore construct their own model, which to a great extent is based upon the Spanish experience with the European Economic Communities. But Spain, of course, was told before it came into the community that it had to create institutions which were compatible with the community, an independent judiciary, independent trade unions. Therefore, the two things are not exactly comparable.

My point is you have to look at the assumptions in these studies before taking them at face value.

Chairman LAFALCE. Dr. Dornbusch and Dr. Woodhead——

Dr. DORNBUSCH. Since the Hofbauer-Schott issue came up, the index refers to page 32 for exchange rates, and the page is blank.

Chairman LAFALCE. You are kidding me.

Dr. DORNBUSCH. The moderates that forecast employment have to assume a real modeling for your relative prices. They do not have the whole monetary sector of the economy, including prices and exchange rates. That is a conventional modeling in economics. Included is a real exchange rate, a real interest rate, a growth rate, a budget, and a whole set of assumptions about what is happening in that economy. Of course, there is plenty of room; if the budget moves, every variable has to move. So I don't think one wants to fault their modeling.

Their modeling starts with how much can be financed in terms of external deficits and works from there to employment impacts, and I think that is a very sound, professional way. If one wants to know different scenarios about sectors, then you have to go to budgets, interest rates, and the exchange rates.

Dr. WOODHEAD. I have to agree that one must look at the assumption made by these models. The beauty of an econometric model is that it can never be defeated by facts, but only by another econometric model. That is why we see the generation of so many models. The reality is that jobs are going to Mexico.

Chairman LAFALCE. Let's get away from that issue now. We can get lost in esoteric terms and concepts, and we can lose sight of what the whole purpose of economics ought to be about; and that is the human condition of men and women and how they are able to live fruitful lives on this planet. Let's talk about that now.

I have been working with the Mexican situation since 1982. I think I was the chief champion in Congress for debt relief for Mexico. I had a very strong provision on that in the 1988 omnibus trade bill, too.

I went down at that time to see the head of the central bank of Mexico, to see the chief debt negotiator, et cetera. There was criticism that the austerity policies that were being demanded by the IMF in order to deal with the problem of external debt and inflation were having a horrendous impact on the everyday lives of the people insofar as both employment and standard of living are concerned.

Now, what has been the situation in Mexico, let's say not from 1982 because we had the crisis, but I remember when Salinas came in December 1, 1988. I was asked to go down for his swearing-in. What has been the standard of living and the employment development within Mexico with the rank-and-file Mexican from that time to the present, and what impact has devaluation had on that? If we follow the policy of drastic disinflation, what impact would that have on employment and living conditions? If we follow the policy of devaluation, what impact would that have?

Mr. Heredia.

Mr. HEREDIA. Thank you, Mr. Chairman.

Chairman LAFALCE. That will be my last question and we will go to other Members.

Mr. HEREDIA. I would like to focus on the first part of your question, because very often we hear that NAFTA will be good for Mexico because Mexico eventually will be a richer country, and a

richer country has a higher budget for environmental oversight, and richer countries have a better record of human rights, et cetera.

In fact, what we have had in Mexico since this administration has been further suppression of wages in a way that minimum wages have lost only during Dr. Salinas-Leon' term, 37 percent of their purchasing power. It is alleged that minimum wages only account for a very small fraction of the labor force, but minimum wages in Mexico still are a very relevant measure of all prices.

Plus you have raised the question, and so has Dr. Levinson, of how Mexican workers are not really allowed to appropriate the benefit of an increased productivity. Let me mention the example of automobile workers, of General Motors workers in the Northern State of Coahuila and in Michigan. They perform more or less the same job; they build more or less the same cars. They have achieved even, I would say, higher levels of quality at certain periods of time; and yet they are paid 10 times less than in Michigan for the same kind of job, the same kind of product, the same kind of car.

Of course, there are a lot of other considerations on how wages are defined in the Mexican economy. But I have to say that in Mexico wages do not have a lot to do with supply and demand. Wages have much more to do with the will of the Mexican Ministry of Labor and of Mexican business and of policymakers to keep this environment of supposed competitiveness through low wages.

Only a month and a half ago you may have heard that Ford Motor Company in Mexico wanted to increase wages beyond the ceiling that the Labor Minister of Mexico has imposed on wages. They were not allowed to. They had to negotiate a way to give the workers a higher increase than allowed by the wage ceiling.

So we have had a policy of wage suppression and free prices for other areas of the economy. When it comes to labor we have a policy of suppression of wages and suppression of rights.

Dr. SALINAS-LEON. Indeed, Mr. Heredia is right that wage control or wage suppression has been a fundamental part of the anti-inflation or stabilization program, or at least a portion of it, that has been severely criticized in Mexico.

In the broader context of the results obtained in matters of fighting against inflation and fiscal discipline, there is a world of difference between the Mexican worker; and this is putting it in terms of human action, not any econometric assumption. Of course, the assumption of how much real wages have they lost in the past can be questioned.

Chairman LAFALCE. What are we talking about, say, from 1982 to the present as far as real wages? From 1988 to the present, what are we talking about in real wages?

Dr. SALINAS-LEON. There are several divergent analyses. The standard estimate from 1976 to 1987 is that the Mexican purchasing power lost 47 percent of its value.

I find a series of divergent analyses. I think it depends on the sector. Manufacturing, even though certain sectors in the manufacturing industry in Mexico show a high differential with wages, nevertheless wages are being more and more linked to productivity.

I must say that my colleague is far more adept at answering that question than I am.

Chairman LaFalce. That was the question I posed. Dr. Ramirez could you comment on it then?

Dr. Ramirez. Yes, Mr. Chairman.

In the years of the crisis, what we call the "debt crisis" from 1982 to 1988, just before Salinas took office, average wages in Mexico fell by 30 percent in real terms.

Chairman LaFalce. Dr. Salinas-Leon indicated it could have been more.

Dr. Ramirez. Average wages. People don't pay the minimum wage anymore. From 1987, when the PACTO started, to 1992, real wages have increased by 10 percent annually. This is contained in the record that I am submitting. This is precisely one of the reasons why the exchange rate has appreciated, and this is precisely one of the reasons why employment is not growing in the manufacturing industry. Because companies are forced to shed labor away because the wage element has become a very substantial element of costs.

I do find multinational firms in the manufacturing industry who tell me the Mexican wage, adjusted for productivity - it is true that in Michigan they gain more, but they produce 10 times more. Adjusted for productivity, I would go as far as saying that the Mexican manufacturing wage has nearly lost its cost advantage vis-a-vis the U.S. manufacturing wage.

Chairman LaFalce. Dr. Salinas-Leon——

Dr. Salinas-Leon. If I could finish the remark in light of - the statistic that Dr. Ramirez produced shows my point that there is a divergence among statistical analyses, how much has been lost or gained in terms of purchasing power. One qualitative indicator is the fact that we are no longer living with 100 percent inflation.

The main argument is precisely because the ones who lost more during inflation were not the rich or the upper economic class; they were those that had less resources available. Those were the ones that suffered the most. That seems, to me, an indicator of how the standard of living measured in human terms has improved during the past 5 years.

Chairman LaFalce. If we have suppression plus devaluation——

Dr. Salinas-Leon. If you had a devaluation follow this, the inflationary stabilization program would come crashing down.

Chairman LaFalce. We should agree on one point: We have a vested interest in bringing about stable exchange rates, correct?

Dr. Salinas-Leon. Yes.

Chairman LaFalce. Mr. Heredia.

Mr. Heredia. I think your question is very relevant because it allows us to take a look into this beautiful picture of 365 million consumers in North America. I am afraid that, in the case of Mexico, out of a population of 86 to 90 million people, you cannot say that beyond 12 to 14 million people are true consumers. There may be a surge in consumption of some sectors of the population, but you are excluding any possibility of consumption by a great chunk of a total population. I say that because, some businesses are willing to give wage increases beyond the wage ceiling that has been imposed by the government, and also because there is a fall-

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ing domestic market and a lot of manufacturing firms are suffering because people who produce goods are not able to buy the very goods they produce.

So my point is, the very proof that wages have suffered and the purchasing power of Mexicans has suffered is the fact that for 75 to 80 percent of the population, it is extremely difficult to buy the very goods they produce.

Dr. DORNBUSCH. If I can comment, first, on facts: The earnings in manufacturing in 1990 grew at 3.6 percent real earnings, at 6.1 in 1991 and 8.1 in 1992. There is a very wide divergence across sectors - retail services - but these are the manufacturing numbers.

Mexico has a big dilemma between employment growth and growth in real——

Chairman LAFALCE. Do we have anything for the aggregate economy as opposed to just manufacturing?

Dr. DORNBUSCH. Insured workers, the average——

Chairman LAFALCE. What is an insured worker?

Dr. DORNBUSCH. Social security system insured, which doesn't cover the whole economy, but it is wider than manufacturing, minus 0.6, 2.8, and 4.5.

Chairman LAFALCE. What percentage of the workers would——

Dr. DORNBUSCH. My guess is 60 percent, to make up a number. Agriculture is out, so——

Chairman LAFALCE. So the total aggregate would come down to what?

Mr. HEREDIA. Sixty percent out of a total labor force of 24 million.

Dr. DORNBUSCH. The extraordinary social problems and extraordinary problems to give people jobs and real wages.

As in the United States, in Mexico there are two ways of going about it. One is to go on a populist rampage to say these people deserve higher wages; and in a competitive open economy, here or there, that would be a serious problem. The second is to create labor market institutions and a climate of investment in education where, in fact, over time real wages rise for more and more people.

I think that is the only feasible strategy here. It has been the program in Mexico, and is the President's program here. I think we should not say those people deserve more unless we have a strategy of how to get it and who pays for it.

Mexico, in 1982, tried the populist rate and that is when real wages fell. In a PACTO there is a simultaneous agreement on prices, the exchange rate and wages to avoid that profit margins be squeezed so that employment falls——

Chairman LAFALCE. Does the PACTO contain a provision with respect to devaluation?

Dr. DORNBUSCH. Yes, that is a very important commitment, so real wages aren't squeezed, profits aren't squeezed, and the budget and competitiveness isn't hurt.

The ability to do incomes policy in Israel, when that country stabilized, and in Mexico has avoided the far bigger catastrophes that occurred elsewhere where one just used tight money and nothing else, for example, Peru. I believe there is an element that has maintained social peace in the face of so much disaster, far more than has been elsewhere possible.

No doubt, in Mexico people are poorer than in 1980, but in 1980 and before, they did crazy things to themselves. They are still paying for that. The biggest bill was run up by the populists, who said there was a cheap answer for everybody.

Chairman LaFalce. Dr. Williamson, Dr. Woodhead——

Dr. Woodhead. I have to comment on some of the statistics raised on real wage gains.

In 1992, the hourly compensation costs for Mexican workers in all of Mexico was $2.35 including mandatory social benefits. But in the maquiladora area, United States multinationals, average wages were $1.64 including benefits. So there is exploitation on both sides of the border.

Two-thirds of the Mexican workers make between one and two times minimum wage, and the minimum wage is $4.67 a day.

Chairman LaFalce. What is that per hour?

Dr. Woodhead. Approximately .68 cents an hour.

Chairman LaFalce. That is the minimum wage?

Dr. Woodhead. Yes, see the attached discussion paper.

[The paper may be found in the appendix.]

Chairman LaFalce. What percentage of workers make that?

Dr. Woodhead. Two-thirds make between one and two times the minimum wage.

On the issue of variation statistics, the National Autonomous University of Mexico estimates that the minimum wage lost 72 percent of its buying power since Salinas took office. So there are government statistics, Bank of Mexico statistics, and there is a more independent source statistics. There is no unanimity on Mexican statistics.

Chairman LaFalce. What is the National Autonomous University of Mexico?

Mr. Heredia. It is the major university in the country.

Dr. Salinas-Leon. Well, the largest.

Mr. Manzullo. Would the gentleman yield?

Chairman LaFalce. Dr. Salinas-Leon, what credibility would you attach to their figures as opposed to the government's figures?

Mr. Heredia. That is the school where the president of Mexico studied economics.

Dr. Salinas-Leon. It is also where Jorge Castenada studied economics.

Dr. Dornbusch. Poor students.

Chairman LaFalce. This was what you were referring to when you said there was discrepancy?

Dr. Salinas-Leon. It is the largest university in Mexico, but there are several other universities that have done other analyses in the wake of the viability - or the possibility of implementing a NAFTA and its impact on real wages in Mexico. It is by no means the most authoritative or the one that is taken for granted.

Chairman LaFalce. I just want to get our facts straight.

Dr. Ramirez, do you think there could be some validity to the finding of this University of Mexico study that the minimum wage has lost 72 percent of its buying power since Salinas took office?

Dr. Ramirez. No, I don't think that is the right figure.

Chairman LaFalce. What do you think the right figure might be?

Dr. RAMIREZ. The minimum wage has fallen by 40 percent in real terms from the year 1988 to date. However, the minimum wage is not the standard rate that we should use in comparing wages between Mexico and the United States, because Mexico has a very large sector of underground economy which does not record their proper earnings. So we have a lot of underestimation there, unrecorded earnings.

But also it has a very large sector of agricultural workers who are on subsistence wages, and this is at or below subsistence levels. I think there is no secret that this sector has increased in size over the last not only 6 years, but 20 years.

This sector may represent one-third of the working age population, which is measured at 24 million workers. This is what we know as "economically active population." So those 40 percent of the population that are at minimum wage, below minimum wage at subsistence levels, are not included in the statistics that we cite here on manufacturing wage rates.

Chairman LAFALCE. Does anyone else want to comment?

Mr. MANZULLO. Mr. Chairman.

Chairman LAFALCE. Let me finish up——

Dr. WILLIAMSON. To reinforce what Rudi Dornbusch said about the populism not being the answer to unreasonably low wages in parts of the economy, Mexico is still a poor economy and there are still many people at that level. The way to overcome that is to let the modern sector of the economy grow, and that probably does mean wage restraint in that sector.

I want to make two comments. One related to what Ford may have said. If I was a Ford director and knew I could only pay a 9.9 percent increase, I think I might say, I would love to pay more. It is a cheap way of getting popularity. I don't think one should take that too seriously.

The other point is to caution against expecting too much from pacts. The Mexico pact has done well. I think it is sensible to have pacts and incomes policies and not just rely on tight macropolicy to reduce inflation, but the idea that that alone can get inflation down to United States levels or below over the course of a year, and thereby avoid the need for further devaluation, strikes me as unrealistic.

I heard a similar story once before. In 1979, I ran a conference on exchange rates and at that time, we had a Mexican paper in which they said that they were not going to devalue the peso, no way. They were going to reduce inflation to less than in the United States. I thought then, Mexico is heading for a crisis; and I looked on with amazement at bankers continuing to pour in money for 2½ years. It took 2½ years for the crisis to come.

One has to have realism, and an acceleration in the crawl is a realistic way of getting the necessary competitiveness at the same time as keeping up the good fight against inflation and permitting continued expansion of the real economy, which in time can tackle these critical social problems that we have been discussing.

Chairman LAFALCE. My intention is to call upon Mr. Baker unless Mr. Manzullo has a followup question.

Mr. MANZULLO. It goes to the gut issue.

One fact that has been ignored at this hearing is that 75 percent of all products sold in the United States originated from Mexico are made with American components. If the peso is devalued, wouldn't that make our United States components more expensive for Mexicans to buy in order to assemble across the border? Wouldn't that put at risk high-paying American jobs involved with this cross-border trade and manufacturing agreement?

For example, for Ford Motor Corporation 75 percent of the value of a Ford car from Mexico is produced in the United States. Thus, 25 percent of the Ford car has Mexican input. If Mexico devalues its currency by half, the Mexican value of the car is cut by 50 to 12.5 percent, but the United States inputs into the Ford car to 150 percent. This makes the Ford car much more expensive to the United States and Mexican consumer, and why would you flood the market with this product?

Dr. SALINAS-LEON. Thank you, Mr. Manzullo. This goes to the heart of the matter, and it would be generalized to a broader proposition in saying, what would happen to all those capital and intermediary imports that Mexico so desperately needs to modernize its productive plant and in some way try to avoid its underdeveloped status? A major devaluation would be a crushing blow to that type of strategy, a strategy that has been active, especially prominent since 1990. Ninety percent of our imports today, globally, from the United States are constituted primarily by capital goods and by intermediary durables. They are absolutely essential to rebuild an undercapitalized economy whose undercapitalization derives from the populism that Dr. Dornbusch and Dr. Williamson were alluding to. This goes to the heart of the matter.

If I may append the saying that those who worry about a major devaluation in the context of U.S. job losses should focus precisely on, if there would be a devaluation today in Mexico, job loss in the United States would be threatened, which is why the decision of the Members of this committee is somehow indirectly relevant to the prospects for a NAFTA and a stable Mexico.

If indeed Mexico today is, as Ross Perot says, making a giant sucking sound in terms of job loss for the United States, this would be a reason not just to reject NAFTA, but to reject all trade with Mexico, all $70 billion worth of it, and all the very high-paying jobs that that creates in the United States.

[Dr. Salinas-Leon's statement may be found in the appendix.]

Chairman LAFALCE. Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I am going to be relatively brief in light of the extensive discussion we have had on the subject. I wish to return to just a few of the comments made earlier in the testimony of the various witnesses talking about the saga of personal bankruptcies, farm credit crises, small business credit crunches, and double-digit unemployment.

I wasn't sure whether we were talking about the economy of Louisiana or that of Mexico. We also are a very oil-dependent, export-oriented State which has seen its economic fortunes dictated by world market conditions rather than our own governmental direction. In fact, in looking at the broader picture using numbers from a Federal Reserve report and other data made available to me

in the hearing today, interest payments on public debt both domestic and foreign are approximately 3.1 percent of GDP for the Mexican system.

The same number for the United States is about 3.2 of gross domestic products. In looking at social program expenditures, it represents about 9 percent for the Mexican GDP and over 10 for the American system, depending on how one defines social programmatic expenditures in our governmental system. So that the relative problems facing the American Government are not too distinctively different from that of Mexico, albeit the American economy is technologically driven, has education opportunity available and one might say has greater potential for recovery, given limited strategic infrastructure and capital resources in the current Mexican environment, suffice it to say the original point of the hearing with regard to devaluation of the peso and currency exchange rates as one element of these overall macroeconomic conditions is of concern.

I didn't want to leave the impression that I think devaluation of any monetary system is an event of no consequence, but I believe without regard to whether there was or was not a free trade agreement given the much larger economic conditions that govern the Mexican economy, and based on those comments of those here earlier, devaluation may well be accelerated if the free trade agreement is not further considered in a positive light by the U.S. Congress.

If we are worried about economic opportunity, governmental stability and reduction of debt service, which I think both Governments are similarly situated, and we may argue to the degree to which either country is threatened by debt service, it would seem to me, without knowledge of the detailed economic theory which I have been blessed with this morning that economic opportunity and job creation and sales of goods and services are what will benefit both countries and both Governments.

How do we best get there? Is it by heightened government regulation and further barriers to economic growth, coming either from our government or from yours? Of course not. We are talking about engaging in trade with the countries whose economic system is approximately of the impact of the State of Florida.

What risk do we take as the Government of the United States by opening our doors on a reasonable basis understanding the risk of the world market that takes the fortunes of a small State like Louisiana and runs us up and down from day-to-day? Isn't it better to have opportunities ahead rather than closed doors through which no one can go?

I will simply say, since this is a question period, did you know?

Chairman LaFalce. Does anybody care to comment on Mr. Baker's question or statement?

Mr. Heredia and Dr. Woodhead.

Mr. Heredia. Thank you, Mr. Baker and Mr. Chairman.

I just would like to finish by saying that we have been advised not to fall into the populist temptation probably because to a good extent in Mexico we have fallen into the elitist temptation, in the sense that in the past 5 or 6 years huge fortunes have been created in Mexico.

At the other extreme, 70 percent of the population are excluded. The fortunes of a handful of people who have benefited from the policies that are defended by some proponents of trickle - down economics are amazing.

Seven Mexicans are listed by Forbes Magazine among the 286 wealthiest people in the world. All of them are worth beyond a billion dollars. I am pretty sure that this kind of caveat not to fall into populism has a lot to do with a handful of people making a lot of money and willing for the status quo to continue the way it is.

Chairman LaFalce. I want to keep it on track. I have some people waiting for me that I must see.

Dr. Woodhead?

Dr. Woodhead. To respond to Mr. Baker on the issue of risk and entering into a trade agreement with Mexico, I think the risks are real. We are at different stages of development.

There are 86 million people south of the border in different stages of democracy and economic development. I think that without a mechanism to control devaluation of the peso, the risk is only made worse. I think that the chairman raises a good point that a fourth supplemental agreement is necessary, because NAFTA explicitly eliminates the possibility of controlling currency values in countries. Maybe somebody has to look carefully at what a peso devaluation may do.

Dr. Dornbusch. When one has some consultative mechanism for exchange rates presumably with some limits, if an exchange rate is trapped the next story is how to finance the imbalances. We can't just legislate an exchange rate and not explain who is going to pay for the stuff.

The United States certainly should not underwrite with Government money Mexican deficits. In Europe, the experience of fixing exchange rates with bilateral agreements to keep them afloat has been disastrous. It is very unpleasant that the Mexicans could be competitive——

Chairman LaFalce. Could you tie this to sustainable current account balances?

Dr. Dornbusch. Precisely that point. We ought to have stable policies here and there if the current account is financed reasonably.

Chairman LaFalce. In the 1988 legislation, we finally decided to target on that.

Dr. Dornbusch. Mexico will have large deficits because they will invest and grow. That is to be included in the definition.

Chairman LaFalce. Dr. Williamson, we will give you the last word.

Dr. Williamson. Mr. Chairman, you anticipated my point. If you have an exchange rate arrangement, which I think would be a good idea, then it certainly ought not to be crafted as an exact replica of the European model. It ought to learn from the European experience.

If I may immodestly mention it, The Economist had an article last week about how that could be done and it happens to draw on work that I have done. [That is why it is immodest to mention it.]

Chairman LaFalce. I didn't read it.

Dr. WILLIAMSON. I would be delighted to send you a copy. The idea is that you start with a target for the current account deficit and work back to exchange rates and then if the markets won't accept the resulting exchange rates you give some financial support. That is the sort of idea that ought to be explored, but not just by replicating the European model.

Chairman LAFALCE. I think this has been an extremely helpful panel and I hope it will provide food for thought for both Mexican and American negotiators as they consider supplemental agreements.

I thank you very much.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

APPENDIX

STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN

COMMITTEE ON SMALL BUSINESS

HEARING ON "NAFTA AND PESO DEVALUATION: A PROBLEM FOR U.S. EXPORTERS?

MAY 20, 1993

This morning the Committee on Small Business meets to ask the question, "Whither the Mexican peso?" The answer, of course, will affect the outcome of U.S. exporters and investors doing business with Mexico. In a NAFTA hearing this Committee held on February 25, one witness--a distinguished Mexican economist, Dr. Jorge Castaneda--raised the peso issue. He said that NAFTA could play a nasty trick on those expecting a large U.S.-export payoff if, in fact, the agreement is followed by an immediate devaluation of the Mexican peso. We convene today to explore this issue with a panel of expert witnesses.

Surprisingly, despite the endless discussions of NAFTA and the advertised potential export and investment benefits to U.S. business, few voices have been heard about the peso-dollar relationship and exchange-rate risk. Yet, since 1981 the peso has fallen from 25 to the dollar to a current 3,200 pesos to the dollar. Mexico's exchange-rate policy has gradually devalued the peso since January 1989. Between 1989 and November 1991, the peso was devalued daily; in November 1991, the Mexican government

established a band with upper and lower limits within which the peso was subject to a managed float. The peso has been allowed to continue devaluing by widening the band on the devaluation side. In January of this year, the Mexican government created the New Peso by moving the decimal. We now have NP3.27:$1.00.

The reviews on the peso's future--or more precisely, the Bank of Mexico's policy--are mixed. There are those who say a major devaluation is inevitable. Gary Hufbauer at the Institute for International Economics reportedly anticipates a substantial devaluation next year in the range of 10-20 percent. Others predict that a forced devaluation might occur this fall if capital inflows become insufficient to finance Mexico's growing current account deficit. Those who contend that a sharp devaluation will not occur--such as World Bank staff--believe Mexico will continue to devalue by widening the band on a daily basis but at a faster speed.

What are the economic trends in Mexico and what are the economic conditions that would foster a sharp devaluation versus a continued or accelerated daily devaluation? Mexico's current-account deficit is rising and this year is expected to reach $27 billion or 8 percent of GDP. This, of course, partly mirrors the jump in U.S. exports to Mexico--over $40 billion last year--most of which are capital goods fueling Mexico's rising investment. Interest rates are high--about 17-18 percent--to draw in needed

capital to cover the deficit as well as to hedge a devaluation risk. High interest rates, however, not only pull in external capital, they also put a drag on the economy. If the deficit widens faster than the inflow of capital to finance it, the Mexican Government will have to decide what to do about the peso. And it will not be an easy decision.

Devaluing the peso will make Mexico's exports more competitive; but it also might discourage imports of capital goods. Expectation of a sharp devaluation could also dampen new investment. Expectations of depreciation flag a currency risk and the need for a higher return on investment to compensate for expected loss. And what about U.S. investors already established in Mexico? There are those who contend that the lack of concern by U.S. and other transnational corporations about future peso devaluation indicates their disinterest in selling to the Mexican domestic market. It is their sales in other currencies, especially dollars, that matter, and a cheap peso helps to sell exports from Mexico.

The exchange-rate relationship between the dollar and peso will profoundly affect how any NAFTA operates and the distribution and nature of benefits. Yet NAFTA establishes no mechanism to coordinate monetary policy between the United States and Mexico, nor does it provide for consultations or corrective measures if exchange rates are used to promote competitiveness. I believe it imperative that both the United States and Canada consider a fourth

supplemental agreement--one that recognizes the importance and impact of exchange rates on the operation of NAFTA. I must add that the 1988 Omnibus Trade and Competitiveness Act contains a provision I authored that requires the Department of the Treasury to annually analyze whether foreign countries are adjusting exchange-rate policies to gain unfair competitive advantage. It further requires the President to coordinate and confer multilaterally with other industrialized nations on macroeconomic policies. This we do with the G-7, a large part of which includes discussions on exchange rates and policy coordination. This 1988 Act also requires the Treasury Secretary to engage in bilateral negotiations on exchange-rate policies used by countries which lead to an unfair trade advantage.

Surely as we enter a free trade agreement with Mexico it is incumbent upon us to be concerned about the exchange-rate relationship between the dollar and peso. We must anticipate the problems caused by sharp changes in currency alignments. Inevitably, such changes could significantly affect trade and investment flows. These would lead to changes in job losses and job gains. I might add that this currency problem is proving to be a major challenge to the European Community's monetary union--as we saw last week when Spain and Portugal announced major devaluations.

I believe it prudent to make provisions in conjunction with NAFTA that call for coordination to achieve currency stabilization goals. Perhaps we should consider an EC-like band as a guide that

would trigger a consultation, coordination, and corrective mechanism if necessary.

To clarify this complicated peso situation, I am pleased to welcome a most distinguished panel of experts: Dr. John Williamson, Senior Fellow at the Institute for International Economics; Dr. Rogelio Ramirez De la O, President of Ecanal, S.A., Mexico City; Dr. Roberto Salinas-Leon, Executive Director, Center for Free Enterprise Research, Mexico City; Mr. Carlos Heredia, Visiting Economist from Mexico City, Development Gap; Dr. Rudiger Dornbusch, Professor of Economics at MIT; Dr. Jerome Levinson, Visiting Fellow at the Economic Policy Institute; and Dr. Gregory Woodhead, Economist with the Task Force on Trade, AFL-CIO.

STATEMENT of REPRESENTATIVE JAN MEYERS
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
"NAFTA AND PESO DEVALUATION"
MAY 20, 1993

Thank you, Mr. Chairman, for holding this hearing on the North American Free Trade Agreement (NAFTA). The topic of today's hearing, whether a possible devaluation of the Mexican Peso would pose a problem for U.S. exporters, is, indeed, an interesting one. In the past several days there has been significant news coverage concerning NAFTA, much of which has focused on proposed changes in how the Mexican Central Bank will operate and the possible repercussions for Mexico's economy if NAFTA is defeated.

While I personally continue to have strong concerns about NAFTA and its impact on American jobs and the environment, I am trying to keep an open mind about the basic concept of a North American agreement on trade. In this regard, Mr. Chairman, I must say that I have admired your leadership in

focusing our Committee on many varied issues concerning NAFTA and I look forward to future hearings where we will have the opportunity to discuss NAFTA and its implications with small business men and women who have experience in trading with our neighbors to the South.

Jim Ramstad

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
May 20, 1993

HEARING ON NAFTA AND THE MEXICAN PESO

Mr. Chairman, I am pleased to welcome our distinguished guests here this morning to discuss the stability of the Mexican economy and its effect on trade with the United States.

As each of the panelists pointed out in their prepared testimony, a successful North American Free Trade Agreement (NAFTA) depends on a stable Mexican currency and economy.

That's why I'm so pleased to have true experts in macroeconomics and exchange rate policy with us this morning to discuss the state of the Mexican economy and the status of the Peso.

I am very pleased to see that so many of our distinguished witnesses support NAFTA. Opening foreign markets to U.S. goods through free trade agreements like NAFTA will help generate the growth and jobs our economy desperately needs.

In our increasingly global economy, it is essential to continue the strong growth in exports we have enjoyed in recent years. Exports accounted for 70 percent of the growth in our country's GNP over the last three years. In 1991, exports reached a record $422 billion. Clearly, without overseas markets for U.S.-made goods, the recent recession would have been even more devastating to our economy and workers.

In recent years, trade-related jobs have grown three times faster than overall job creation. In my state, there are some 95,000 jobs directly related to foreign trade. Almost 2,000 Minnesota businesses export.

I certainly believe NAFTA, as originally drafted, will promote even greater export growth and economic prosperity for U.S. workers and companies. But I must say I am concerned about certain pending side agreements, which I understand may include some mechanisms that actually restrict trade with Mexico.

I certainly hope the Administration's negotiators recognize that preserving the spirit of NAFTA, as originally drafted, is essential to its success, and that NAFTA is vitally important to the small businesses of our country.

Mr. Chairman, thanks again for calling this important hearing. I look forward to hearing from our witnesses this morning.

OPENING STATEMENT OF
REP. RON KLINK
COMMITTEE ON SMALL BUSINESS
HEARING ON NAFTA AND THE DEVALUATION OF THE PESO
MAY 20, 1993

Thank you Mr. Chairman. I am pleased that the Small Business Committee is continuing its inquiry into the North American Free Trade Agreement and its implications. One possible implication is the devaluation of the Mexican peso.

As I have said before in this Committee, I believe NAFTA, as it currently stands, is not a good agreement. NAFTA may very well send hundreds of thousands of American jobs to Mexico.

There are no guarantees for the high-paying, high-tech jobs that NAFTA is supposed to create. In fact, in addition to the elimination of American jobs, a trade agreement with Mexico may pull American wages down without raising Mexican wages.

While I have heard claims from my home state of Pennsylvania that exports have increased to Mexico in recent years, people fail to realize Mexico's advantage under NAFTA of being allowed to retain their tariffs on certain products from the United States. This would encourage U.S. companies to manufacture products in Mexico.

I am concerned about the effect of NAFTA on several U.S. industries, particularly glass, appliances and autos. I am also concerned about NAFTA's effect on agriculture and the environment.

Furthermore, we hear that Mexico plans to devaluate its currency by as much as 20 percent once NAFTA is implemented. If the devaluation of the peso were to occur, the price of goods produced outside of Mexico would increase. This would generate a greater competitive advantage for Mexican products by making them less expensive in the U.S. and by inflating the price of U.S. made products.

While I admit that I am not an authority on economic theory, it appears that nobody is certain of the consequences of the NAFTA treaty. I hope this discussion with the panel before us will help answer these questions.

OPENING STATEMENT BY THE HONORABLE DON MANZULLO BEFORE THE SMALL BUSINESS COMMITTEE HEARING ON THE DEVALUATION OF THE MEXICAN PESO ISSUE

May 20, 1993

Mr. Chairman, first let my thank you for holding this hearing today and allowing a witness I personally requested to testify before the committee. The courtesy you extended to me as a freshman is deeply appreciated. This shows me that all I've heard about you as a fair chairman is true. Thank you.

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I commend you, Mr. Chairman, for holding a hearing on this subject today. There has been much speculation in the press about the value of the peso after Congress deals with the North American Free Trade Agreement. I will anxiously await the entire testimony of all the witnesses to hear their perspective on this issue. It is time to get at the root of this issue and put the rumors to rest.

Hearing on NAFTA and the Peso Devaluation May 20
Congressman Walter R. Tucker, III

IT IS A PLEASURE FOR ME TO BE HERE TO LISTEN TO THE TESTIMONY ON NAFTA AND THE DEVALUATION OF THE PESO. TODAY THE SMALL BUSINESS COMMUNITY IS FINDING IT MORE AND MORE DIFFICULT TO GET THE CAPITAL IT NEEDS TO OPERATE AND EXPAND. I WILL BE VERY INTERESTED TO HEAR HOW NAFTA WILL AFFECT THE SMALL BUSINESS COMMUNITY. AS YOU MAY BE AWARE THERE ARE THOSE OF US IN CONGRESS WHO ARE VERY CONCERNED ABOUT THE IMPACT THAT THE NORTH AMERICAN FREE TRADE AGREEMENT WILL HAVE ON THE WORKERS OF OUR COUNTRY. I THANK YOU ALL FOR COMING HERE TODAY AND THANK YOU MR. CHAIRMAN.

EXCHANGE-RATE POLICY IN MEXICO

John Williamson
Senior Fellow
Institute for International Economics

Testimony before the Committee on Small Business of the US House of Representatives

May 20, 1993

Over the past ten years Mexico has introduced a bold and well-conceived package of economic reforms, embracing liberalization of both the domestic economy and its international trade and, more recently, achieving a fair measure of inflation stabilization. The reforms, followed by the Brady Plan debt restructuring, permitted recovery from the debt crisis: a return to positive per capita growth, a restoration of social and educational spending, and an upturn in the real wage from the depressed levels witnessed during the crisis period. Growth has not (yet) approached the rates of 6 percent per year or more that Mexico reached during the oil boom prior to the debt crisis and that we know semi-industrial countries to be capable of achieving during a phase of catchup growth, but the sustained increase in investment holds out hope of stronger growth rates ahead.

This rosy prospect faces two threats. One would stem from a rejection of the NAFTA, which might well undermine confidence in the permanence of the new policy regime. The other arises from the massive current account deficit that has developed in Mexico, with its implied threat of a devaluation of the Mexican peso. It is this threat which these well-timed Hearings are being held to assess.

The Extent of Overvaluation

The reason for believing that the Mexican peso is currently somewhat overvalued is the dangerously large current account deficit that has emerged despite a rather moderate rate of growth. As shown in the table, the current account deficit in 1992 surged to $20.8 billion, some 6.5 percent of GDP, despite a growth rate of only some 2.5 percent (no more than 0.6 percent per capita). The deterioration in the current account reflected entirely a weakening in the trade account, which resulted from the combination of stagnant exports and a continued surge in imports.

The obvious explanation of this weak trade performance is the level of the real (i.e., inflation-adjusted) exchange rate. The table shows that using wholesale prices as deflators the real effective exchange rate for nonoil exports was already back to a

level almost as appreciated as in the pre-debt crisis years 1979-81 in the first 9 months of 1992. Using CPIs as deflators the exchange rate was still some 10 percent more competitive than prior to the debt crisis, but it was vastly more appreciated than during the intervening period. One would have expected both the extensive trade liberalization undertaken by Mexico since the mid-1980s and the large reduction in the price of Mexico's staple export commodity (oil) to have created a need for a substantial net real depreciation, rather than the negligible or modest real depreciation (depending on the price index used) relative to the pre-debt crisis level that now prevails. In the circumstances it is hardly surprising that Mexico has moved into massive current account deficit even in the absence of a domestic boom.

Mexican officials have sometimes argued that the current account deficit need not be a cause for concern because it is the private sector rather than the government that is borrowing abroad. This is an argument that was used in Chile in 1981 and by Nigel Lawson in Britain in 1988: in both cases the foreign borrowing eventually led to an economic crisis despite the government's own finances being in good shape.

A more persuasive argument is that many of the goods being imported are capital goods needed to modernize the Mexican economy, and that when the investment projects currently under construction come on stream they will result in increased exports. For example, during a visit to Washington last September, Pedro Aspé (the Mexican Minister of Finance) stated that the Mexican government estimated that investment already underway in the automobile industry would strengthen the current account balance by some $7 billion per year in due course. Although private fixed investment has increased at a healthy annual average rate of close to 13 percent since 1987, it is not clear that this optimistic view of the prospects in a particular industry is representative of the outlook for the economy in general rather than being uncharacteristically strong. What we do know is that only some 25 percent of Mexican imports consist of capital goods. It would therefore be rash to assume that the deficit will cure itself automatically through the output resulting from the capital goods currently being imported.

If the problem cannot be relied on to cure itself automatically, it is necessary to compare the deficit that currently exists with the maximum deficit consistent with prudence. For a relatively slowly growing country, this would be around 2 percent, or at most 3 percent, of GDP. For a rapidly growing country, as much as 3.5 percent or 4 percent of GDP would

be safely sustainable.[1] Mexico is currently growing rather slowly but there is reason to hope that the growth rate will soon accelerate; in this circumstance the maximum prudent deficit might be some 3 percent (at most 4 percent) of GDP.

This has to be compared to the 1992 deficit of some 6.5 percent of GDP. The mere fact that this was easily financed by capital inflows, including a substantial volume of repatriation of flight capital, should not give much cause for comfort. For one thing, interest rates were substantially raised in mid-1992 after Ross Perot attacked NAFTA, with the apparent intention of sustaining the capital inflow, despite the cost in terms of a slowdown in the already weak rate of growth. More fundamentally, capital markets have an undistinguished record of anticipating problems: most investors operate on the principle that a borrower is creditworthy as long as everyone else is wanting to lend to it, which leads to abrupt cutoffs of credit when confidence is finally called into question.

The task is therefore one of cutting the current account deficit by some 3 percent of GDP, or $10 billion, without diminishing the growth rate. One of my colleagues, William R. Cline, has estimated a model that includes an equation explaining Mexican trade.[2] His model implies that each 1 percent real depreciation of the peso would improve the Mexican balance of payments by some 1.12 percent of Mexican exports of goods and services, currently running at around $42 billion per year. Hence a 1 percent real depreciation would be worth about $500 million.[3] This estimate permits one to work back and calculate how much the peso needs to be depreciated in real terms. It

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[1] A common rule of thumb suggests that the ratio of foreign debt (D) to GDP (Y) should not be allowed to exceed 40 percent. A country growing at 2 percent per year will have a rate of growth of nominal dollar income of some 5 percent per year, while a country growing at 6 percent per year will see its nominal dollar income rise at 9 percent per year (assuming 3 percent inflation in the United States). Since $\hat{D}/Y = \hat{D}/D.D/Y = \hat{Y}/Y.D/Y$ in steady state (when $\hat{D}/D = \hat{Y}/Y$), the maximum safely sustainable current account deficit is 2 percent of GDP under 2 percent growth and 3.6 percent of GDP under 6 percent growth.

[2] William R. Cline, United States External Adjustment and the World Economy (Washington: Institute for International Economics, 1989), table 5.6, p. 211.

[3] The model assumes that the level of real output remains unchanged both in Mexico and abroad; in practice a Mexican develuation probably tends to be recessionary in the short run but expansionary in the longer run as the effects of expenditure switching come on stream.

suggests that the peso is currently overvalued by as much as 20 percent if no allowance is made for the incipient capacity expansion in the auto industry, or by as little as 6 percent if $7 billion is deducted on that account from the target for adjustment by the exchange rate.

Another factor that has pushed up the Mexican deficit is the recession in the United States. Conventional estimates seem to be that this has increased the Mexican trade deficit by something like $3 billion. If this is correct, and if credit is taken for the full $7 billion of anticipated improvement in the auto sector, then it is just conceivable that there is no overvaluation at all. But it would be rash to base policy on that best case materializing: a best guess would be that the overvaluation is of the order of 10 percent.

Realigning the Peso

It would therefore be desirable to achieve a real devaluation of the peso of around 10 percent. There is no prospect of such a devaluation being achieved under the present exchange-rate policy. At present the bottom[4] of the exchange-rate band is depreciating at 40 (old) Mexican cents per day or 4.6 percent per year. Since Mexican inflation is currently running at around 10 percent per year and even the official forecast does not anticipate it falling below 9 percent this year, while inflation in the United States (Mexico's dominant trade partner) is around 2.5 percent or at most 3 percent, the most optimistic possibility would be for avoiding any further loss in competitiveness, rather than for a decisive reversal of the trend. A best guess might be that present policy implies accepting a further 1 percent loss of competitiveness this year.

Incomes policy (the series of Pactos) has been used in Mexico since 1987 to reduce inflation without pushing the economy into an unnecessarily deep recession. Even if it could deliver a further 3 percent cut in wage increases next year, the result would be no more than a marginal gain in competitiveness.

Mexico needs a quicker and more decisive improvement in competitiveness, which can be achieved only via a depreciation of the nominal exchange rate. There are two ways in which that could be realized. One would be via a sudden, discrete devaluation of at least 10 percent (a "maxi" devaluation). The other would be by accelerating the rate of crawling devaluation of the lower limit of the band.

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[4] I use the Anglo-Saxon terminology, in which the bottom of the band is the weakest value of the peso. Latin terminology would call this the top of the band.

I would counsel strongly against a maxi devaluation. The mere belief in the market that the authorities were contemplating such a step would prompt a renewed flight from the peso, to combat which the authorities would have to increase interest rates and thus further impede a growth recovery. If the government succeeded in acting before the markets expected action, it is easy to believe that many investors would feel themselves to have been tricked and that in consequence confidence would evaporate very much more quickly the next time the country encountered difficult times. A maxi devaluation would presumably be regarded by the unions as a betrayal of the Pacto, and would therefore be likely to prompt a renewal of extravagant wage claims. In short, the stabilization gains that Mexico has won so painfully over the past five and a half years could easily be squandered overnight.

A much less risky policy would be to accelerate the rate of crawling depreciation. This was already done once, last September, although not by enough to do more than at the very best prevent a further erosion in the country's competitive position. That acceleration did not prevent the government achieving a further reduction in the rate of wage increase agreed when the Pacto was renewed, nor did it undermine confidence in the financial markets.

How much of an acceleration in the crawl would be needed? There is no need to aim to eliminate the whole of the overvaluation in one or even two years; provided that the markets can perceive that visible progress is being made in eliminating it without abandoning the rules of the game (no more discrete devaluations) they have implicitly been promised, authorities as competent as those in Mexico will have no difficulty in preserving confidence.

An acceleration of the crawl will have some costs associated with it. The clearest cost is that it will postpone further progress in reducing inflation, for one must anticipate that additional depreciation will increase wage claims and otherwise serve to make inflation faster than it otherwise would be. It will be of critical success to the program that the government succeed in minimizing the passthrough from faster depreciation to increased inflation.

Suppose that the passthrough were one-third. Then a 6 percent acceleration in the rate of crawl would result in inflation going up to 11 percent rather than down to 9 percent, which would be unwelcome but vastly preferable to the possibility of the stabilization program collapsing as the market forced a maxi devaluation. Competitiveness would improve by 3 percent a year rather than declining by 1 percent, which would allow the estimated overvaluation to be eliminated over a period of some three years. If that were judged too lengthy, either a faster

acceleration of the crawl, or greater success in containing passthrough, would be needed.

Would an incease in the crawl by (say) 6 percent imply a need to increase the peso interest rate? At present Mexican dollar-denominated 28-day bills (Tesobonos) yield 4.1 percent, as against a yield of 2.8 percent on 28-day US Treasury bills, suggesting that short-term Mexican country risk is some 1.3 percent. Mexican peso-denominated 28-day Treasury bills (CETES) yield 15.3 percent, implying a peso-dollar yield differential due to currency factors of (15.3 - 4.1) = 10.2 percent. 4.6 percent of that yield differential serves to compensate for the existing crawl, leaving 5.6 percent as a risk premium to cover the possibility of a maxi devaluation of the peso. If an acceleration of the crawl increased policy credibility, it is thus possible that a faster crawl would carry no penalty in terms of higher nominal interest rates. I conclude that it is unlikely that an extra 6 percent or so on the crawl would imply a need to increase the interest rate by much, if anything.

Note also that the real interest rate will fall if the nominal interest rate remains constant, because of the somewhat faster inflation to be expected in Mexico. Furthermore, the prospect of a more competitive real exchange rate will enhance the attractiveness of investment in tradables, which will also serve to increase aggregate demand. Over time the improvement in the trade balance will serve to strengthen demand as well. Thus this program would be consistent with an increase in the Mexican growth rate to take advantage of the possibilities of catchup.

Concluding Remarks

Mexico's impressive program of stabilization and liberalization is endangered by the overvaluation of the peso that has now emerged. Fortunately this overvaluation is not so drastic (probably in the range of 10 percent) as to be incurable through an acceleration in the rate of crawling devaluation, which would preserve the gains from the stabilization program largely intact. Such a policy adjustment will require some short-run sacrifices by Mexico, notably a postponement of the ambition to get inflation securely down into single digits. But its promise of a medium-run recovery in growth momentum and an escape from the danger of a return to debilitating crises make the price in terms of somewhat higher short-run inflation well worth paying.

A reinforcement of Mexico's commitment to avoiding maxi devaluations in the future is also very much in the interests of its future NAFTA partners, the United States and Canada. The European Community has found it necessary to limit exchange-rate flexibility so as to safeguard the European common market, and large capricious changes in the exchange rate of the peso would be similarly dangerous to NAFTA. It might even be appropriate to

extend exchange-rate collaboration among the three member countries, so as to eliminate any danger of competitive devaluation. The exchange-rate strategy recommended above would provide a good foundation for such cooperation.

THE MEXICAN ECONOMY, 1979-92

	1979-81	1982-84	1985-87	1988	1989	1990	1991	1992
GDP growth (%)	8.5	-0.7	0.2	1.2	3.3	4.4	3.6	2.5
Population growth (%)	2.8	2.3	2.1	2.0	2.0	2.0	2.0	1.9
CPI inflation (%, Dec/Dec)	n.a.	79.6	109.5	51.7	19.7	29.9	18.8	12.9
Current account ($ billions)	-10.8	1.1	1.1	-2.4	-4.0	-7.1	-13.3	-20.8
Growth of non-oil exports (%)	9.6	13.4	18.5	15.2	7.5	13.1	12.0	1.3
Growth of imports (%)	45.2	-13.5	3.6	54.6	23.9	27.8	27.4	26.1
Real effective exchange rate (1985=100) a :								
CPI-deflated	82	108	128	118	110	108	98	91
WPI-deflated	88	114	121	112	107	107	96	90
GDP ($ billions)	n.a.	n.a.	n.a.	173	205	242	283	320

Figures for 1979-87 are annual averages

Sources: Economic Commission for Latin America and the Caribbean; International Financial Statistics (IMF); EXIM Review "Mexico" (Fall 1991); Embassy of Mexico, Washington, DC; SECOFI (Mexican Trade Ministry); and Banco de Mexico.

a - increase indicates real peso depreciation.

TESTIMONY BY ROGELIO RAMIREZ DE LA O BEFORE THE SMALL BUSINESS COMMITTEE OF THE HOUSE OF REPRESENTATIVES, CONGRESS OF THE UNITED STATES, 20 MAY 1993

MEXICO: OUTLOOK, POLICY AND THE PESO

Since 1987, the Mexican Government has followed an anti-inflation strategy that, while it has ensured a dramatic improvement in public finances, depends largely on the stability of the peso exchange rate against the US dollar. This strategy was implemented gradually over the past five years in order to cushion the social costs and high levels of unemployment that usually accompany stabilization programs. Using the exchange rate to lead this program, as is usual in other programs of economic stabilization caused a significant real appreciation of the peso.

There is some concern today in domestic and international financial markets over the peso real exchange rate and Mexico's ability to sustain large trade deficits. This concern has heightened as the implications of a strong exchange rate become clearer, in particular the effect on domestic activity and growth potential of high interest rates required to attract foreign capital.

Background: The Anti-inflation Strategy

In December 1987, the Mexican Government instituted a social pact to distribute the costs of fighting inflation between business, workers and government. The Pact of Economic Solidarity called for producers to limit price increases, for workers to moderate demands for pay rise, and for the Government to abide by a policy of fiscal austerity and monetary discipline to guarantee the stability of the peso. Commitments were adopted over short periods, and their renewal required a guaranteed nominal exchange rate over the following term. While this Pact has been in force, annual inflation has fallen from 159% in December 1987 to 10.3% today.

In 1988, the Pact dictated that the peso remain fixed against the US dollar. One year later, as inflation remained high, it began to slip by Ps 1.00 per day or -15.9% annually, while inflation was 19.7% in the year to December 1989.

One year later the Pact, renamed Pact of Stability and Economic Growth (PECE), reduced the daily slippage of the currency to Ps 0.80 per day or 9.8% annually, but inflation jumped to 29.9% in December 1990, owing to a premature relaxation of anti-inflation policies. It became clear that reducing inflation would require additional fiscal

discipline, a tighter monetary policy and greater efforts to control wage increases.

Until then the Pact had successfully controlled increases in "minimum" wages, which in the 1980s fell over -30% in real terms. By the end of the decade, however, most modern manufacturing firms were paying higher rates than the minimum wage, and their increases systematically outpaced those in the National Consumer Price Index, as is shown in Table I. Growing competition from imports obliged firms to become more efficient, reducing personnel and installing more capital-intensive equipment, but also tying wage increases to higher productivity for the workers they kept on.

In an attempt to reduce inflationary expectations, the Government's program for 1991 further reduced the daily slippage of the peso against the dollar to Ps 0.40 per day, an annual depreciation of 4.8 percent. With consumer inflation of 15.9% for the year, the daily slide implied a continued appreciation of the peso, while the trade deficit expanded to -$11.1 billion and the current account to -$13.286 billion.

Government officials diffused some early concern over the rising trade deficit by emphasizing that Mexico was importing foreign capital needed by the private sector to

invest and buy capital goods abroad. Unlike large trade deficits of the past, the external deficit of the current economic cycle was not related to excessive public expenditure, since the Budget deficit as a percentage of GDP was reduced to one fourth from 1987 to 1990, and was to register a surplus of 1.8% in 1991 and 0.5% in 1992

Encouraged by progress against inflation, a high inflow of capital and renewed enthusiasm about Mexico's economic outlook in the international financial markets, in November 1991 the Government decreased the daily slippage of the peso to Ps 0.20 per day, representing an annual adjustment of only 2.3%, compared with 11.9% inflation in the same year. In addition, the Bank of Mexico adopted a new exchange regime under which the rate at which banks would buy dollars in the retail market would remain fixed until March 1992, while the selling rate would rise by the daily slippage of Ps 0.20. This gave rise to a slowly widening exchange-rate band whose extremes were the minimum purchasing rate and the rate sliding daily. The band was intended to facilitate a small daily adjustment of the peso in a fluctuating market and to spare the monetary authority the need to constantly intervene for a given nominal rate.

Greater concern over the future stability of the peso was excited by the expansion of the trade deficit in 1992 to a record -$20.6 billion and the current-account shortfall of

-$22.8 billion or -6.9% of GDP, particularly as interest rates had to rise abruptly from the middle of the year in order to keep foreign capital flowing into peso investments. This led, in October 1992, to a renewal of the Pact with some new measures. One was that the slippage of the peso would increase rather than fall, from Ps 0.20 to Ps 0.40 per day, representing an annual adjustment of -4.6 percent. Another was a new name for the Pact (although its Spanish acronym - PECE - remained the same): the Pact for Stability, Competitiveness and Employment. This was a recognition that the competitiveness of the peso exchange rate now deserved greater attention. The reference to employment was significant owing to the combined negative effects on employment and activity of high interest, a high exchange rate and reductions in trade tariffs, as is shown in Table II. The market reacted positively to the changes as pressures eased against the peso and interest rates began to fall. This showed that investors had been more troubled by uncertainty over the policy which the government would follow than by the rate of exchange rate depreciation. It must be noted, however, that interest rates were high enough to accommodate the increased slippage.

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Inflation and the Exchange Rate

The official target for the peso in 1993 represents an annual slippage of -4.6% at the upper end of the band and consumer inflation of 7.0 percent. This means that real appreciation will be virtually halted this year, if we take into account US consumer inflation of about 3% and further increases in Mexican productivity. It is still unclear, however, how much the accumulated real appreciation in recent years has cut export profits, encouraged imports and created an exchange-rate risk that necessitates a high premium on peso interest rates.

During the application of the anti-inflation Pact, the Mexican Government implemented important economic reforms that transformed the markets for goods and services, but, not surprisingly, industries competing with imports or in foreign markets were forced to increase efficiency at a much faster pace than those facing no external competition. This was reflected in a large gap between price increases for tradable goods and those in non-tradable goods and services, representing a squeeze on the profits of exporters and firms competing against imports.

From the implementation of the first Pact in December 1987 until the end of 1992, Mexican consumer prices increased 213.6% compared to the increase in US consumer

prices of 22.9 percent. The peso was adjusted downwards against the dollar by 41.7%, which means that in terms of Purchasing Power Parity (PPP), it suffered a real appreciation against the dollar of 80.1 percent. PPP, however, is a crude measurement of a currency's real value, since it does not incorporate the effect of higher productivity increases in Mexico compared with the US.

Adjusted by the rate of productivity growth in manufacturing industry, which in Mexico reached an accumulated 17.0% over the period 1987-1992 (compared with 3.0% in the US), the real appreciation of the peso is closer to 58.5%, still a substantial appreciation.

Some analysts suggest that an analysis of the peso's real appreciation must be limited to the manufacturing sector, which competes in world markets, and based on wages instead of consumer prices. Mexican average manufacturing wages rose by 491.5% between 1987 and 1992, while US wages increased 16.2 percent. Adjusted for the peso's loss of value against the dollar over the same period and for average productivity increases, the excessive rise in Mexican wages represents a real appreciation of 216.2% against the dollar. This, in fact, reflects Mexican consumers' greater access to imported goods since the base year of 1987. Although Mexican wages are much lower than US wages and thus can rise without affecting competitiveness,

the Mexican worker's average productivity level is also much lower. Adjusting for differential wages and average productivity, Mexican labor is found to remain competitive, but it had also lost much of its cost advantage over US labor at equivalent levels of productivity by the end of 1992. This is in spite of the fact that in some industrial processes, labor costs and productivity in Mexico are considered much more advantageous and are attractive to foreign investors. For the economy as a whole and for the purposes of appraising the real peso exchange rate, the important elements are average wages and productivity, since these are the ones that affect the macroeconomy. Table III shows the movement in wage costs and productivity in both countries.

Movements in Relative Prices

Other measurements using different groups of prices in Mexico confirm a significant shift in relative prices between 1987 and 1992, which worked against producers of tradable goods.

The Bank of Mexico's price index of tradable goods increased between November 1987 and March 1993 by 200.0%, while the index of non-tradable goods rose 528.4 percent. Among the latter, certain goods and services are clearly not

facing any competition, indicating that efficiency in these industries has not risen as fast as in manufacturing industry. Telephone rates jumped by 456.9%, electricity by 389.2%, and gasoline by 320.7%, exceeding the rise of tradable goods by 128.4%, 94.6%, and 60.4% respectively. These increases are shown in Table IV.

Manufacturing industry was adversely affected by the change in relative prices, although it was also forced to become more efficient where producers were able to increase investment, upgrade equipment and improve management. Many manufacturing sectors were unable to respond favorably to such pressures, as can be seen from their negative or nil rates of growth in output shown in Table II. It cannot be denied, however, that some well capitalized firms not only managed to stay afloat but also increased output and expanded exports, including companies involved in manufacturing automobiles, cement, glass, chemicals and some electronics. The capacity of manufacturing to continue operations under the current exchange rate is therefore variable. Although some large exporters cited the strong peso as a cause of lower profits in their reports for the first quarter of 1993, it is difficult to determine how much the fall in profits owes to the slowdown in the US market. It is clear, though, that maintaining the peso exchange rate will require relatively high rates of interest that will further weaken the potential for employment. Between 1987

and 1991, employment recorded nil growth in manufacturing and fell in textiles, wood, paper, and non-metallic minerals.

This partly explains why growth of gross domestic product decelerated from 4.4% in 1990 to 3.6% in 1991 and 2.6% in 1992. Nevertheless, private consumption and investment grew at relatively high levels, mainly representing expenditure diverted to imports. Gross capital formation rose 10.8% in 1991 and 13.9% in 1992, while private consumption rose 5.0% and 5.9% over the same period. This was financed by a huge inflow of foreign capital, which was lent by the newly re-privatized commercial banks to the private sector. This credit jumped 122.9% in real terms or 30.6% annually between 1987 and 1992.

The large inflows of foreign capital reflected the participation of Mexican and foreign investors in the privatization of state enterprises and the new opportunities for business. Simultaneously, as traders in international financial centers observed that the Government had fulfilled its commitment to maintaining a given nominal exchange rate, they were attracted by high peso interest rates. Even with an annual depreciation of the exchange rate implicit in its widening band, interest rates remained attractive enough for short-term investors in fixed-income securities. In 1992, such capital represented 40% of total private capital

inflows on the capital account of the balance of payments, which recorded a net surplus of $26.0 billion.

Outlook for the Peso

The strong exchange rate of the peso can be sustained by business confidence and foreign capital inflows, as long as domestic economic reforms continue to open up new opportunities for capital with relatively high rates of return in the future. The Mexican Government, in addition to the privatization of state enterprises, also announced its intention to sign a Free Trade Agreement with its two North American trading partners, Canada and the United States. This agreement (NAFTA) was regarded by Mexican business as another major turning point in the process of economic reform, as it would seal the strategy for an open economy, set clear rules on trade and foreign investment, and adopt industrial and investment regulations consistent with those of our two northern partners. NAFTA would thus reduce the risk of future changes in Mexican economic policy, a great plus in the eyes of businessmen and a reason to continue investing in Mexico.

The incentives for foreign capital created by economic reform and business confidence have so far been more

powerful than the deterrents of a large current deficit and shifting relative prices.

Nevertheless, in the presence of uncertainty over Mexico's capacity to finance growing trade deficits in the event of a change in business expectations, investors have recently become more cautious about their peso investments. This caution is partly based on the real peso appreciation accumulated so far and the economic weakness associated with high interest rates. The outlook for the peso largely depends on long-term equity capital being mobilized to Mexico, allowing interest rates to drop and improving growth potential. This possibility is in the short term associated with expectations of the approval of NAFTA, but in the long run Mexico's economic performance can create a good business climate for long-term investment.

Aside from the large shift in relative prices mentioned above and the exceedingly rapid growth in credit for consumption, Mexico's economic fundamentals remain sound, in particular because the Government has avoided a fiscal deficit and further indebtedness. Therefore, apart from the peso fragility in the short term, the currency's outlook for the medium term is promising. This is now enhanced by President Salinas' initiative to change the Constitution in order to grant autonomy to the Bank of Mexico in the management of monetary policy.

Current Policy: the System of Peso Fluctuation

The peso could be adjusted by market pressures, and the present band of fluctuation would allow it to depreciate by 8% over the next year without a change in exchange-rate policy. Moreover, the Government has indicated that amplifying the band of fluctuation is an ongoing option, a view strongly shared by investors. Its adjustment, however, would vary depending on the presence or absence of international confidence and continued inflows of capital. With business confidence high, a steady adjustment in the exchange rate can be spread over a period of twelve or eighteen months, in the same fashion as the dollar adjusts against European currencies or the Japanese yen. Eliminating or reducing the unfavorable trend in relative prices, however, would depend much more on anti-inflation policies than on the adjustment of the exchange rate. This is because if a devaluation is large enough, it inevitably reignites inflation and invalidates the currency movement in the first place. This is why exchange-rate policy has to be so finely balanced and why it cannot be effective in adjusting exchange rates unless accompanied by tight fiscal or monetary policy or both, whose role is to control inflation. An effective adjustment, therefore, would have to be modest and probably gradual in order to avoid new inflationary forces and keep financial markets confident.

A peso slide within its band would be more difficult, however, in the presence of market pressures and a continued slowdown in economic activity, as foreign capital would remain very cautious. Among other problems, a widening band promises a future depreciation, such that any increase in the slide would need to be compensated for by higher interest rates, difficult to reconcile with a recovery in economic activity. Only large inflows of long-term equity investment can break this vicious circle. In their absence, reliance on short-term funds calls for higher interest rates. This makes the slide in the exchange rate self-defeating in the end, as high rates hurt output and employment. In such a context, short-term investors could not fail to see an erosion in the consensus for a strong exchange rate. We witnessed the same developments in some European countries that participated in the Exchange Rate Mechanism last September.

Concluding Note

The Mexican peso is today fluctuatimg within a band which the authorities decided to amplify last October, to allow the market to make adjustments according to its perception of the currency's value and risks. Until now the market has remained in favour of peso investments, despite the knowledge of an expanding current deficit, relative price

shifts unfavorable to exports and a slowdown in activity caused by high interest rates. The reason is that there exists reasonable confidence that Mexico can handle these economic adjustments gradually and that it will have time to do so as long-term equity capital enters the country. This is largely dependent on the approval of NAFTA.

In the absence of NAFTA, the markets are likely to bring pressure to bear against the peso. At present, the fluctuation band for the peso can accommodate a reasonable adjustment, but the Government has also indicated that this band can be widened if necessary to allow the peso to adjust at higher rates of depreciation. The mechanism to adjust the peso is thus in place, but the advantages of too fast a depreciation are unclear, as an excessive adjustment could damage investor confidence and upset the delicately built social pact by stoking inflation. The Mexican Government is thus expected to combine a moderate depreciation with additional measures to boost business confidence and open up new opportunities for private business, further deregulating economic activity and continuing with the privatization of state enterprises.

Over the medium term, the peso is likely to maintain its strength once relative prices are realigned and the profitability of Mexican manufacturing is restored. Economic growth is likely to maintain moderate rates, while market

uncertainty persists in the short term. Even so, the growth in imports is bound to continue as investment activity and private consumption record relatively high rates of growth. Since growth in demand is the most important cause of the increase in imports, international trade is likely to continue growing even in the presence of a gradual adjustment in the peso.

A distinction must be made between the NAFTA as a trade policy tool and the depreciation of the peso as part of Mexico's exchange-rate policy. Representatives in the US Congress should not be too worried about short-term movements in the peso exchange rate, for this is not likely to affect the strength of the Mexican market over the medium term if Mexican macroeconomic policy is sound. They should also bear in mind that trade policy and the debate over NAFTA is a longer-term policy issue, whose analysis should not be mixed with short-term issues such as monetary or exchange-rate policy in Mexico.

Table I
Increases in Mexico's Average Manufacturing Wages and Costs and in Consumer Prices
(percentages)

Year	Manufacturing wages	Cost of labour in manufacturing	Consumer Price Index
1988	113.7	110.9	114.5
1989	30.8	30.3	20.0
1990	30.3	29.8	26.6
1991	30.5	28.4	22.7
1992	25.7	26.4	15.5

Source: Bank of Mexico

Table II
Growth in Manufacturing Output and Employment
(1985=100)

	1985	1987	1990	1991	Annual rate of growth 87-91	Jan-Nov 92/91 (% increase)
Manufacturing output						
Total	100.0	96.7	120.7	124.9	6.6	1.9
Food, beverages	100.0	98.9	126.0	128.8	6.8	0.7
Textiles	100.0	90.7	99.7	95.7	1.4	-1.5
Wood	100.0	103.0	87.9	86.4	-4.3	0.8
Paper	100.0	117.9	122.8	121.4	0.7	0.8
Chemicals	100.0	103.4	145.6	149.9	9.7	3.5
Non-metallic minerals	100.0	98.6	104.8	106.0	1.8	7.0
Basic metals	100.0	103.8	117.2	114.1	2.4	-2.4
Metallic products, machinery	100.0	88.7	130.2	149.8	14.0	0.1
Other	100.0	103.9	97.1	95.8	-2.0	30.2
"Maquiladora"	100.0	218.3	350.0	341.1	11.8	6.9
Manufacturing employment						
Total	100.0	97.2	100.0	98.4	0.3	-3.7
Food, beverages	100.0	102.7	108.0	108.7	1.4	0.6
Textiles	100.0	97.1	90.5	85.8	-3.0	-4.9
Wood	100.0	98.8	91.0	89.9	-2.3	-3.8
Paper	100.0	101.0	101.1	99.7	-0.3	-4.0
Chemicals	100.0	101.8	104.9	103.1	0.3	-3.9
Non-metallic minerals	100.0	99.6	102.5	98.4	-0.3	-2.3
Basic metals	100.0	80.1	75.7	70.6	-3.1	-12.5
Metallic products, machinery	100.0	95.1	103.5	103.9	2.2	-4.4
Other	100.0	89.3	102.4	103.9	3.9	-4.0
"Maquiladora"	100.0	145.5	215.5	223.2	11.3	8.3
Output / employment						
Total	100.0	99.5	120.7	126.9	6.3	5.6
Food, beverages	100.0	96.3	116.7	118.5	5.3	0.1
Textiles	100.0	93.4	110.2	111.6	4.6	3.4
Wood	100.0	104.2	96.6	96.1	-2.0	4.5
Paper	100.0	116.7	121.4	121.8	1.1	4.8
Chemicals	100.0	101.6	138.8	145.4	9.4	7.4
Non-metallic minerals	100.0	99.0	102.2	107.8	2.2	9.3
Basic metals	100.0	129.5	154.7	161.6	5.7	10.1
Metallic products, machinery	100.0	93.2	125.8	144.2	11.5	4.5
Other	100.0	116.4	94.8	92.2	-5.7	34.2
"Maquiladora"	100.0	150.0	162.4	152.8	0.5	-1.4

Source: Institute of Information and Statistics (INEGI) and Banco de Mexico, "Indicadores Economicos" February 1993

Table III
Prices, Exchange Rate and Productivity in Mexico and the US
Dec. 1987 = 100

Year	Consumer Price Index Mexico	Mexican manufacturing wages	Consumer Price Index USA	US manufacturing wages	Nominal peso / $ exchange rate	Labor productivity in manufacturing Mexico	Labor productivity in manufacturing USA
1988	151.7	211.4	104.4	103.0	2281.0	0.998	1.01
1989	181.5	276.5	109.4	106.1	2641.0	1.039	1.00
1990	235.9	360.3	116.2	110.1	2945.4	1.080	1.00
1991	280.2	470.4	119.4	113.1	3071.0	1.130	1.01
1992	313.6	591.5	122.9	116.2	3115.4	1.170	1.03

Source: Bank of Mexico and US Committee of Economic Advisors to the President

Table IV

Accumulated Price Increases in Mexico 1987 - 1992

(%)

Consumer prices	Tradable goods	Non-tradable goods	House rents	Telephone	Electricity	Gasoline	Producer prices
269.6	200.0	528.4	663.0	456.9	389.2	320.7	158.1

Source: Bank of Mexico, Price Indices

TESTIMONY OF ROBERTO SALINAS-LEON
EXECUTIVE DIRECTOR
CENTRO DE INVESTIGACIONES SOBRE LA LIBRE EMPRESA
MEXICO CITY, MEXICO
BEFORE THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

THURSDAY, MAY 20, 1993

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify before you today on the topic of North American Free Trade and exchange-rate stability in Mexico. I am a Mexican scholar who shares the growing awareness among my fellow citizens that forging of closer commercial ties with the U.S. under the North American Free Trade Agreement (NAFTA) constitutes a crucial mechanism to consolidate the economic course of stable and sustained growth brought about through the wave of market-oriented reform which has characterized my country's progress during the last five years.

The timeliness of these hearings on the future of the peso-dollar parity and its impact in the development of U.S. imports and investment in Mexico could not be more exact. But the reason for this transcends the latter concern. Mr. Chairman, three days ago a presidential initiative was issued decreeing the independence of monetary policy from the government. This dramatic announcement implies the full autonomy of the Banco de Mexico with respect to the management of inflation targets, exchange-rate stability, interest rates, and other important items of monetary policy. So far, this reform has been received as a reliable institutional guarantee of long-term price stability and long-term health in public finances. By formally severing the government's financial needs for cash from the role of the central bank of strengthening the purchasing power of our currency, the Salinas administration has established the irreversibility of fiscal discipline and balanced budgets. Thus, the government will no longer be able to rely on quick financing of populist programs via the inflationary course of monetary expansion- ism. In this way, price and exchange-rate stability become institutionalized.

NAFTA is considered another fundamental strategic tool to cement the changes fashioned in the wake of responsible fiscal policy, large-scale privatization of inefficient state-run enterprises and aggressive trade liberalization. Notwithstanding the immense socioeconomic benefits of three-way free trade in North America, the agreement has been the object of much irrational criticism on the part of labor and environmental organizations in the U.S. The vast majority of this special interests onslaught has been exclusively extra-

commercial, from fear of mass job-displacement in the U.S. to Mexico's political credibility, and even issues of cultural identity. The newest concern of a sharp devaluation of the peso viz-a-viz the dollar following the implementation of NAFTA fits this unfortunate category.

There are several overwhelming arguments against the desirability of a devaluation to boost Mexican exports and inhibit U.S. imports. It is not the implementation of NAFTA that makes a difference with respect to the peso's stability, but just the opposite. In the absence of NAFTA, economic expectations would plummet and with it Mexico's opportunity to adequately service the financial needs of a required expansion in its private sector current account deficit. In short, Mr. Chairman, and Members of the Committee, if you vote against NAFTA you are indirectly contributing to a potential and crushing devaluation in Mexico. The Mexico-based companies you all represent, together with the jobs they sustain, would find their position jeopardized.

THE STRATEGIC SIGNIFICANCE OF NAFTA

Mr. Chairman, as an instrument of public policy, NAFTA plays a dual role in the transformation of my country's economy. With the formation of NAFTA, Mexico stands on the threshold of becoming a major force in global trade. This would enable Mexico to enjoy membership within the largest market in the world, with $6.2 trillion in economic output and a consumer market of 360 million people. This is 25 percent larger than the twelve nations that make up the EC. A fundamental question for the future of Mexico's economy is: where does NAFTA fit in? In brief, the accord is symbolic of the profound transformations undertaken during the Salinas government. It is a supra-national and institutional guarantee that the future of Mexico has changed for the better. NAFTA, therefore, is both a culmination of the process of trade liberalization and, more importantly, a public policy item which consolidates the process of internal, economic structural reform. In other words, it symbolizes the irreversibility of market-based polices, making changes independent of the political whimsy of future administrations. A stable rate of exchange is fundamental to the prospects of this consolidation.

The strategic impact of full three-way free trade in the North American continent for Mexico is pre-eminent. There are four fundamental reasons for the desirability of developing a closer trade relationship. The first argument centers on the need for order. Mexico and the U.S. already enjoy a flourishing trade relationship. In 1992, two-way trade exceeded $70 billion US— almost triple the amount in 1986, when Mexico joined GATT in 1986. This trade inertia will continue with or without a NAFTA-style arrangement. Indeed, the U.S.-Mexico border has been identified as the most rapidly expanding zone in the world. The NAFTA framework, so construed, represents an attempt to supply legal order to this booming bilateral trade relation.

The U.S. is Mexico's most important commercial partner. 70 percent of Mexico's imports come from the U.S., and some 65 percent of its exports find a home in U.S. markets. Similarly, 64 percent of total foreign investment is constituted by U.S. capital. By the same token, Mexico represents a very attractive market for U.S. exports. It is already the U.S.'s third largest trading partner, ahead of powerhouses like the U.K. and West

Germany. In 1992, it overtook Japan's place in manufactured trading, and it is on the brink of becoming number two in the U.S.'s trading priority. Such facts reveal that a future agreement on trade matters was inevitable.

The second argument for NAFTA in Mexico is: diversification. In effect, open trade liberalization has greatly transformed the structure of Mexico's external sector. The latter has diversified its exports and its performance in the world markets. Manufactured goods are growing at a steady rate of 15% per anum, and represent 55% of the count-ry's total external output.. In contrast, prior to trade liberalization, oil exports dominated the external sector by some 75%. Today, oil sales abroad constitute less than 30%. So seen, NAFTA constitutes an opportunity to further diversify Mexico's trade structures as well as to attain higher levels of domestic competitiveness via duty-free market access. A stable exchange-rate is fundamental to meet this objective by divorcing trade performance from the artificial stimulus provided by exchange-rate manipulation and linking it instead to higher levels of productivity.

The concept of competitiveness supplies the third fundamental argument for NAFTA in Mexico. Mexico's private sector has begun to adapt to global economic change and the challenges of world integration. NAFTA is crucial to forge a strong and sufficiently competitive business sector, able to compete worldwide and penetrate new markets abroad, as well as to maximize comparative advantages. NAFTA lays the foundations of competitiveness, by providing broad-based rules to allow for long-term planning, access to updated technology, incentives to specialize, and free entry to the largest market in the world.

The trend toward modernization is already visible. As the liberalization of trade has moved ahead, the country has recorded explosive current account deficits, as a result of an increase in private investment inflows (some $21 billion US in 1992, 6 percent of GDP). The high surpluses in the capital account have been used to finance intermediary durables and capital-intensive goods, which together account for some 88% of total net imports. NAFTA stipulates that 84% percent of exportable goods (some 7,300 products) will receive full duty-free and quantitative-free treatment, as of January 1, 1994. This affords an enormous opportunity to capture economies of scale and to attain greater cost competitiveness. Similarly, 40% of U.S. and Canadian goods will be subject to immediate phase-outs as of the same date. The important consequence of this percentage is that most of it is constituted by high technology and modern equipment. In this way, Mexico will have access to capital and intermediate products free of tariff restrictions and thereby accelerate the urgent process of modernizing the productive plant. Medium- and small-size companies will gain an opportunity to specia-lize at far greater degrees.

A fourth and potent argument for NAFTA has been repeatedly underscored by Treasury Undersecretary Lawrence Summers, in his diagnosis of the strategic effects of regional trade blocs. This is that NAFTA will balance out the capital needs of a severely undercapitalized economy, depleted by the inherent wastefulness of 1980s statism and protectionism. In a sense, NAFTA is less a trade accord than an investment strategy intended to generate resources to finance new jobs. As Salinas de Gortari is fond of stating, Mexico seeks to "export goods, not people."

The 1990s are characteristically an era of acute capital scarcity. In effect, of the total stock of world

investment today, only 25 percent is destined to the less developed world. For Mexico, it is imperative to continue attracting a large flow of new capital investments, in view of the huge requirements to attain a sustained and stable high growth rate. The NAFTA arrangement was negotiated to meet this challenge: forge a superior and reliable investment regime. This is an extra-commercial aspect of the accord, albeit one that is crucially important to the economic strategy in place. So while 1993 remains a mystery as to the future of the treaty, one thing is certain: the country needs it in order to supply investors, inside and outside, with long-term guarantees that government will be bound to follow good public policy.

Mexico's uncontested progress in economic reform and liberalization of trade, has made the goals of reaching a free economy a fully realizable option. It is eager to become part of the first-world. In the past, illegal immigration, corruption, paternalism and state giantism hurt the country's potential and prospects for economic growth. Now, the "lost decade is over" and a new epoch lies ahead. Mexico is a nation of 82 million persons, 60% of which are under the age of 30. To realize its full potential as a leading trade player, however, more work remains to be done, both in entrepreneurial and institutional matters.

Yet, Mr. Chairman, this is where NAFTA enters as a fundamental strategic item: it forces the government to follow a competitive public policy, and generate the institutional conditions for developing a prosperous society.

INVESTMENT AND INSTITUTIONAL REFORM

Mexico's ongoing efforts to attract new capital investment constitutes an integral part of the program of economic structural reform. The positive results obtained in fiscal discipline and wholesale liberalization have generated an attractive investment regime. Indeed, the once-fantastical target of $24 billion in capital flows projected for the entire six-year term of the Salinas administration has already been met: $28.8 billion to date, 18 months ahead of schedule, and with projected inflows of an additional $22 billion before the conclusion of the current presidency. A crucial issue confronting the administration is how to make these badly needed private capital flows permanent.

This issue has been the source of considerable speculation on the part of observers and investors who worry about domestic recession, a fragile exchange-rate and a disproportionately high trade imbalance. The conventional presumption is that a sharp devaluation is necessary to remove the overvaluation of the peso viz-a-viz the U.S. dollar, and thereby enable exporters to compete successfully in global markets. Last year's expansion of the exchange-rate ceiling from 20 to 40 centavos a day seems to have been guided by this view.

Mr. Chairman, I believe this appearance is misleading. The primary motivation governing the initiative to slightly increase the daily microdepreciation of the currency was to neutralize a rapidly growing expectation that a devaluation was just around the corner. High interest rates have helped to temper the speculative onslaught against the peso's real monetary appreciation. But they did not suffice. While the move was risky, it appears to have issued in positive fruit: money-markets have since stabilized, and the stock exchange is (despite occasional jolts) is again gaining momentum.

The advocates of devaluation ignore that the latter represents a strategically unavailable option for the Salinas administration. First, it does not correct the alleged trade disadvantage represented by the enormous gap between imports and exports (a $20 billion deficit in 1992). The policy objective, of course, is to somehow generate a trade advantage for exports, by adjusting the price differentials between the U.S. and Mexico and removing a 15% to 20% margin of "overvaluation". Yet, the recent history of widespread instability in Mexico between 1976-1987, suggests that devaluation led to runaway inflation and capital flight while failing to improve balance of payments conditions.

A substantial peso-dollar parity adjustment will merely work in the short-run. By making imported consumer goods and much-needed foreign intermediary durables and capital-intensive goods more expensive, a devaluation issues in price instability and inflationary inertia. Higher domestic wages and prices then cancels out the short-term benefits accrued to exporters. In the medium term, a resurgence of inflation renders exporters with a far less competitive position.

A great deal has been achieved to consolidate monetary and fiscal discipline. Thus, witness the latest official report that public finances registered a 0.5% of GDP surplus in the first quarter of 1993. The annual 1.7% target is more ambitious than the results obtained in 1992 (0.5%), but entirely feasible in light of this new data and the and the burst of confidence occasioned by the announcement of an independent monetary policy. While other items of reform are pending (eg., reducing public sector current expenditures), a shift in the nominal exchange-rate would destroy the climate of relative confidence, obtained via the various stabilization measures adopted thus far. The current supply-side strategy is to reduce inflationary differentials rapidly, and compensate the loss of exchange-rate competitiveness with increased productivity, through deregulation incentives in many sectors of the economy. This rationale lies behind the many policy initiatives to foster direct private investments in housing, potable water distribution, mining, fishing, aquaculture, port and airport privatization, secondary petro-chemical privatization. In addition, there are significant forthcoming changes in tourism and in the legislation governing foreign investment.

Since 1988, current account deficits have been accompanied by extensive capital account surpluses. Intermediate and capital goods account for 88% of the current import structure, thereby helping the productive plant to modernize. This trend is certain to continue, in the framework of growing trade integration under NAFTA. The government's commitment to budget surpluses indicates that private sector investment flows have been the principal source of financing current deficits. In the meantime, hard-currency reserves maintain record heights ($18.2 billion, the latest estimate). As the recent success stories of export-oriented economies like Spain, South Korea and Japan demonstrate, trade opening in the initial stages requires current deficits of up to 12% of GDP.

In Mexico, the current account deficit is estimated to rise to some 7-8% in 1993. The expectation is that NAFTA will cement a highly positive investment climate capable of attracting $10 to $12 billion US annually. In a recent study, the Ciemex-Wefa firm estimates that approval of NAFTA will lead to annual investment flows of up to $17 billion per anum. Conversely, a rejection of NAFTA will cause a loss of $4 billion in potential investment and inevitable negative results in inflation and growth rates. The current deficit would shrink to $10

billion, but the price would be paid at the expense of capital losses in an undercapitalized economy.

Indeed, market access is a secondary concern. Yet this renders the requirements of obtaining sustained capital account surpluses highly volatile and dependent on the future of an external factor, like NAFTA. For this reason, the focus of concern should lie less in a (predictably) expanding trade deficit and much more on how to guarantee that incoming capital will continue to find itself in domestic, productive enterprises. Yet, this reflects a problem concerning the requirements of the capital account and the institutional framework governing foreign investment flows. A solid private property rights legal framework, plus a new round of tax and regulatory incentives, are necessary to stimulate Mexico's "export potential". Domestic exporters will benefit far more from increased productivity, available high-tec equipment and cheaper credit, than from the artificial (and counterproductive) stimulus of a devaluation.

Official sources estimate that Mexico requires $150 billion in new investment and savings during the next ten years in order to grow at the rates needed to service a very rapidly expanding workforce (1 million per year). Such is the concern that underpins the emphasis on competitiveness and price stability. The real answer to balancing the interests of private foreign investors and domestic exporters lies in wholesale economic stability. This requires not a deviation of monetary and exchange-rate policy, but increased efforts to liberalize an overly concentrated capital market and economic activity in general.

A CURRENT ACCOUNT OF MEXICO'S CURRENT ACCOUNT

The aforementioned efforts reflect a popular saying in Mexico made famous by Pedro Aspe, to the effect that "many obstacles lie ahead, but Mexico is on its way to-wards a new economic miracle". Few would contest the Minister of Finance, but for one point. This has to do with Mexico's huge trade deficit, which has surpassed official projections during the past two years by as much as 150%. Not surprisingly, the likelihood of a $20 billion trade deficit and $27 billion current deficit in 1993 has caused the business community and general populace in Mexico to speculate about a possible drain on outstanding foreign reserves and growing pressures to devalue the currency. Similarly, the International Monetary Fund has expressed blunt and all-too-familiar reservations about a "trade imbalance" and an "unfavorable" evolution of the balance of payments. The fact is that Mexico now imports a lot more than what it exports, and this has set off many noisy sounds of alarm.

The country's rate of import growth has averaged a spectacular 29% in the past two years, in contrast to a comparatively meager 5.1 percent growth in exports.. The alarm over this mounting red ink in trade statistics has a historical basis. Mexico seems rapidly approaching a current account deficit similar in GDP terms to the one recorded in 1981, which then set the stage for an ensuing avalanche of devaluations and hyperinflation. The end product was a "lost decade". The issue, of course, is whether this concern has a basis in Mexico's current economic reality.

Mr. Chairman, I believe this comparison harbors crucial dissimilarities. As Aspe has stated, a "deficit in the current account means that expenditures surpass revenues". In the early 80s this difference owed to a huge foreign

debt accumulation and massive public sector spending in inefficient state-run ventures. But in today's framework of market-oriented reform it means that the private sector is spending capital coming in from abroad (foreign and repatriated) to finance profitable projects at home. In short, the current account deficit is a reflection of an investment boom and the climate of economic confidence the country now enjoys.

The close causal link between the current and capital accounts reflects the positive impact of Mexico's strides in growth-oriented policies and fiscal adjustment. The concern over an increasing current deficit overlooks that global capital seeks regions with superior investment climates. Thus, if my country had a surplus in the current account it would be exporting capital, when it needs to be doing the reverse: obtaining overseas funds to finance private growth. In fact, Mexico registered substantial trade surpluses in the early and mid-80s, a time better remembered for exchange-rate havoc and a massive exodus of domestic savings.

The crucial logical point is that the advent of growing current deficits is not the outcome of government borrowing to finance inefficient public concerns. The government is committed to balanced budgets and has institutionally ruled out a return to deficit spending by legally rendering monetary policy independent of the wishes and whims of presidents in power. Moreover, the government is today reaping the fruit of fiscal health by amortizing a substantial portion of outstanding public sector debt, both domestic and foreign. This historic trend in fiscal order entails that the current account deficit is being financed by private sources.

Mr. Aspe again explains: "When there is a private sector current account deficit, there is at the same time a private sector capital account surplus". Hence, the differential between imports and exports is necessarily covered by private investment flows, "so there is no reason to expect devaluations, recessions or hyperinflation". In fact, there is every reason to expect the opposite: 3 to 4% economic growth rates during the past five years.

Mexico's current account deficit has become a mechanism for modernization and import-led growth. Indeed, large current account deficits are inevitable in the con- text of trade liberalization and are bound to widen as integration in a North American trade bloc takes place. This finding is confirmed by recent several recent studies, including the Ciemex-Wefa report cited earlier ($29 billion current deficits from 1994-1998).

To many observers, this is unsustainable. Such concern springs from yet another worry of how to erase current account red ink. The capital account surpluses are the result of investments in financial instruments of high liquidity. This is "volatile" capital, highly vulnerable to sudden shifts in investor perception. This time the critics are right: it is estimated that 6 out of every 10 incoming dollars are deposited in short-term portfolio assets and government T-bills with high yields. Thus, the danger looms that increasingly growing current deficits will be serviced by quicksilver capital flows which can flee else- where as a result of unexpected outcomes.

This danger partially owes to Mexico's persistent and illogically harsh foreign investment restrictions in financial markets. While "institutional" investment is on the upswing, capital markets lack diversity in offering attractive medium and long-run investment opportunities in controlling shares. A salient instance of this failing is the "terms of sale" of commercial banks. Foreign investors are merely allowed a maximum 30 percent ownership in non-voting shares. This fails to inspire long-run ownership confidence or add a permanence factor to investment options.

This scenario harbors a crucial policy implication for future efforts to sustain growth-oriented trade deficits. Thus, to ensure safe and consistent flows of productive investment, the Salinas administration will eventually need to soften up extant restrictions in the foreign investment regime. Private economist Rogelio Ramirez de la O predicts that annual investment flows between $8 to $10 billion are required to the financing of the current account. "It is hard", he says, "to imagine foreign investment of such magnitude without a major opening of energy and financial sectors to private investors".

I would add three factors to the requirements for obtaining reliable private capital flows. First, institutionalization of anti-inflationary fiscal and monetary policy. This, Mr. Chairman, is exactly what occurred three days ago. Second, implementation of NAFTA. This will consolidate long-term security by forcing future administrations to play by the rules of a trilateral trade framework. Third, a wholesale reform in the institutional framework of property ownership. Some constitutional provisions (eg., articles 27 and 28) fail to guarantee private property ownership, while others (eg., articles 25 and 26) are potential backdoors for government intervention in every facet of economic life. The need of capturing new overseas investment to fund prolonged current account deficits make a shift away from the model of "economic rectorship" a matter of practical necessity.

Mr. Chairman, the likelihood of price and exchange stability of the peso is relative to the implementation of NAFTA and its strategic contribution in forging responsible domestic policy. True enough, major policy reforms are still needed to balance the requirements of sustained capital surpluses. These will occur, as they have occurred, relative to the needs of consolidating an open and competitive economy.

CONCLUSION

Twenty-one years, more than two decades and a full generation. Such is the time which has elapsed for Mexico to return to the privileged days of single-digit inflation rates. Although Mexico enjoyed three decades of sustained stability and growth prior to the devaluation and inflation disasters of the 70s and 80s, an estimated forty-five million citizens do not know what it is to labor, live and leisure in a single-digit environment. In 1993, this will change. The 7% official target is beginning to appear realizable. The annual rate is already at 10.4%.

Mr. Chairman, the consistent practice of fiscal discipline has been an essential policy item to bring about this salient success in stabilization. However, it is not without opposition and cause of concern. The government reports that it enjoys the financial resources necessary to strengthen its healthy balance sheet, by using a portion of high reserves and windfall revenue from recent privatizations to retire outstanding public debt. The latter stands at 24% of GDP, down from well over 60% in 1988. Thus, a further 10% reduction in internal debt is in the planning stages. This would obviously have positive effects on interest rate obligations

On the other hand, the monetary appreciation of the peso viz-a-viz the U.S. dollar, owing to a differential between a 4.5% microdepreciation under the crawl system and inflation, as well as the inflationary differentials between Mexico and the U.S., continues to fuel negative exchange-rate expectations. The alleged overvaluation

of the peso is also widely perceived as a factor behind the high growth in the current account deficit, which may well reach 8% of GDP this year— with or without NAFTA in place.

The problem, Mr. Chairman, lies less in a predictable expansion of the trade deficit in an open and undercapitalized economy like ours as it does in the long-term institutional requirements for sustained capital account surpluses. That is, the country needs to institutionalize safety, by way of long-term ownership guarantees for foreign investment. This task is considerable, but the recent decree to make the central bank independent and the new Foreign Investment Law, represent in the right direction.

However, more is required. The prospects for such reforms are encouraging and are bound to gain momentum with NAFTA in place. This will require exchange-rate stability as a basis of investor confidence. A sharp devaluation would destroy all the confidence gained so far and spur a resurgence of the inflationary spiral. This would wipe out any artificial competitive advantages gained through exchange-rate manipulation in the medium-term, owing to a widening of the inflationary gap between the Mexican and U.S. rates.

The only way to align the exchange-rate is via the fight against inflation. This task would be formally sealed with the approval of NAFTA in 1993. Rhetorically, Mr. Chair- man, I believe that the current government would be more willing to divest its petrol concerns, even sell the pyramids, than recur to the strategic disaster of a devaluation. Therefore, I urge you and the members of this committee to give Mexico the vote of confidence it deserves and vote to approve implementing legislation for NAFTA. Other- wise, the U.S. interests in Mexico which you represent, along with the rest of them, will be far more vulnerable to the prospects of a devaluation and the damage that entails for job-generating commercial growth. In today's era of globalization and change, it is the responsibility of our leaders to enable consenting adults across borders to freely and voluntarily exchange goods and services. I urge you and your colleagues to vote "yes" for North American peace and prosperity.

THANK YOU

THE DEVELOPMENT GROUP FOR ALTERNATIVE POLICIES

THE DEVELOPMENT GAP

STATEMENT OF CARLOS HEREDIA
DIRECTOR OF INTERNATIONAL PROGRAMS, EQUIPO PUEBLO
AND VISITING FELLOW, THE DEVELOPMENT GAP
BEFORE THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
20 MAY 1993

Good morning. My name is Carlos Heredia. I am an economist, formerly with the Mexican Ministry of Finance and now working with the Mexican Non-Governmental (NGO) community. I come to the United States through a partnership between The Development GAP and Equipo PUEBLO, a Mexican NGO. This is part of a wider rapprochement between citizen coalitions promoting economic justice and democratization in our two countries.

Mr. Chairman, I would like to thank you and your staff for inviting me to testify in this hearing. The Development GAP and Equipo PUEBLO have done extensive work on the impact of structural adjustment policies on the workers, the family farms and the people of our two nations. Today I want to focus particularly on the high cost that the current model of economic liberalization has imposed on small business and small farmers in Mexico. In particular, I will discuss the effect of extremely high real interest rates and an overvalued currency on these sectors of the population.

The Political Economy of Devaluations in Mexico

Is the peso overvalued? The number of analyses that say it is has increased in recent weeks. Should the peso be devalued? Conflicting opinions on this point have multiplied in the last couple of months, and confusion prevails. Will the Mexican government be able to postpone a devaluation of the peso until NAFTA is ratified, or to avoid a devaluation altogether? Right now, all bets are off.

Let me now describe what devaluations have meant for different sectors of the population in Mexico. They have always been traumatic, because deep inside Mexicans are led to believe that devaluing the national currency is paramount to an offense to national pride. One Mexican president went as far as stating that "a President who devalues the currency, devalues himself." So, beyond economic implications, there are a lot of political consequences to a devaluation. With the presidential elections looming on the horizon, a devaluation would seriously hurt the possibilities of the three Cabinet members most often seen as the leading PRI (Partido Revolucionario Institucional) candidates.

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Historically, Mexico's upper class has an extremely high propensity to import, one that rests upon a well established habit called "malinchismo" by Mexicans. Although the Central Bank continues to claim that capital and intermediate goods account for 80% of total imports, some analysts believe that this figure is riddled with methodological problems. According to the Bank's method of classification, most of Mexico's imports have resulted in an enhancement of the country's productive capacity or, at the very least, the upkeep of current production levels. The truth is, however, that there is not all that much new creation of real capital, but rather a massive surge in imports of consumer goods.

Relative exchange-rate stability since December 1987 has been a blessing for the middle class, and certainly for the conspicuous consumption habits of the rich. Many analysts have pointed out that there is a strong correlation between the popularity of Mexican presidents vis-a-vis these segments of the population and the stability of the peso/dollar rate. For the majority of the population, though, a devaluation can very well mean a tragedy to the extent that it translates into higher domestic prices.

Paradoxically enough, the very policies advocated to achieve stability have fostered the current instability. Since 1986, and especially after 1989, the quick-paced, across-the-board economic liberalization and indiscriminate tariff reduction have resulted in a deluge of imports from all over the world, but mainly from the United States. The authorities have pointed out that this opening to imports was consistent with reining in inflation, because a lot of imported goods were cheaper than their Mexican equivalents. It was time to lift protection, we heard, and make the national manufacturers become more efficient. But in this respect, as in many others, we outdid our trading partners, and many a local producer was priced out of the market. This did not have to do only with efficiency, but with economies of scale, and, most of all, with access to cheap credit and consequent low financial costs.

We now have relatively stable prices, but they are at levels that are not affordable to the majority of the population. Wages continue to be suppressed in an effort, supposedly, to remain competitive. There is an increasing gap between income and purchasing power for most Mexicans, and even a family income of two to three times the minimum wage (currently $125 a month) is not enough to pay for a "basic basket" of goods and services.

The Impact on Small Business and Consumers

In a period when we supposedly have a healthy growth of the economy, non-performing loans are going through the roof. Such loans used to account for no more than two or three percent of the portfolio of any given Mexican bank; now they are in excess of eight percent of all outstanding loans in the system. Mexican middle class consumers are facing enormous difficulties in paying their mortgages and their car loans.

Servicing their debt becomes too heavy a burden, so many people are ultimately forced to give up their assets. Mexico's foreign debt has been rescheduled several times, but how is this massive indebtedness of Mexican consumers going to be rescheduled? Who will bail them out?

Neither the commercial banks nor the government would publicly admit that this situation is widespread. Not the commercial bankers, because they paid a very high price for the recently privatized banks. Not the government, because this crisis damages the myth that trickle-down economics is expanding the domestic market and benefitting everyone.

Right now in Mexico the overwhelming majority of productive establishments are fighting to survive. Even many of those big, publicly owned firms whose stock is traded on the Mexican Bolsa incurred losses in the first quarter of 1993. These firms have access to external financing in dollars at 8 to 10% interest rates, instead of the rates of 35% to 40% available in pesos to smaller companies. For most of the last two years, real interest rates in Mexico have been over 2.5 times higher than comparable rates in the United States. It is difficult for small businesses to use loans at such high rates. The spread between active and passive rates has not been reduced enough. An effort by the Central Bank in the last few weeks to bring rates paid on Mexican Treasury Bills (Cetes) to a 15% level seems to have touched bottom, and it is likely rates will bounce back in the following weeks. As of 31 March 1993, foreigners owned 78% of public holdings of Cetes.

Take now the unemployment figures. According to official data, the unemployment rate in January was only 3.5% of the workforce, as opposed to 7.0% in the US and 11.0% in Canada. This unemployment figure is one that not even those who compile the statistics believe, because they know their methodology is biased: people are asked whether they have been employed or have looked for work for at least one hour in the past nine weeks to be counted amongst the official work force.

Out of a workforce of around 28 million people, only 12 million belong in the so-called "modern" sector. One would think that the 130,000 workers dismissed by PEMEX alone in the last two years would make the unemployment figure go up, but officially it hasn't budged.

Many larger businesses are firing employees. The banks, the public enterprises that are being streamlined to be privatized, etc., can afford to do so. In the case of small businesses, the combination of high real interest rates, "fiscal terrorism", and the absence of the rule of law have created a hostile environment that is forcing them to close shop. As a result, the current level of employment in the manufacturing sector is still under the 1988 level when the Salinas Administration was inaugurated, and well below the 1980 level.

The Impact on Peasants and Small Family Farms

One of the most significant components of the adjustment policy related to the agricultural sector is the reduction of credit for the production of basic grains and for regions considered to be less productive. In an upcoming study for the NGO Working Group on the World Bank, we have found that the federal government has been phasing out development-bank credit, with the total number of hectares receiving credit from Banrural between 1987 and 1992 falling from 7.5 million to 1.3 million. In the last ten years, the number of producers receiving credit from Banrural fell from 2.5 million to only half a million. The government has, since 1989, offered loans through Pronasol, the social-investment fund, but that credit is severely limited.

Mr. Chairman, let me illustrate this with the ordeal that small rural producers in the state of Chihuahua are facing. Only a few weeks ago, they staged a tractor blockade of a border-crossing bridge between Ciudad Juarez and El Paso to call attention to the severe debt crisis affecting their communities. Small producers in Chihuahua are much better off than peasants in Central and Southeastern Mexico; yet this crisis has forced them to send various members of their families to work in the United States. In fact, a peasant federation in Chihuahua is planning a massive walk and border-crossing to the United States, in what has already been called "the NAFTA Exodus", to again call attention to their need for urgent debt relief and accessible credit.

NAFTA, it is claimed, will stem the northward flow of migrant workers. However, it, like the related liberalization policies of the past decade, would, in its current form, favors corporations and banks over the needs of small producers, farmworkers and poor communities. So, in reality, the northward migration would only intensify.

A Secret Exchange Rate Deal in NAFTA?

The question remains open as to whether the Mulroney government, at the outset of the negotiations for the U.S.-Canada Free Trade Agreement, made a secret commitment to the U.S. to raise the value of the Canadian dollar relative to the U.S. dollar. In "Take Back the Nation 2," a book by Maude Barlow and Bruce Campbell published in Canada earlier this year, the authors tell us that, in 1985, former Tory industry minister Sinclair Stevens told the Toronto Star that his U.S. counterpart, Malcolm Baldridge, indicated that a dollar deal was the key to getting a free-trade agreement. Baldridge told Stevens that it would have to rise close to the 90-cent range and remain there for four years. The dollar was trading at 71 cents U.S. at the time.

The U.S. National Association of Manufacturers warned that there could not be a free-trade agreement unless there was a deal on exchange rates. They saw the negotiations as a way to force up the Canadian dollar and thereby reduce Canada's trade surplus with the United States, which was Cdn. $20 billion in 1985.

In late 1986, Chief U.S. trade negotiator Peter Murphy told an audience of U.S. and Canadian business executives that, although the exchange rate was not formally on the free-trade bargaining table, the U.S. Congress saw it and free trade as "inextricably linked". By October 1987 the Canadian dollar had climbed to 75 cents and a year later to 83 cents, and from the beginning of 1989 through most of 1991 the dollar stayed between 85 and 87 cents U.S. Currency traders observed that the Bank of Canada intervened very heavily in the currency markets when necessary to ensure that the Canadian dollar stayed within this range. We have seen U.S. retailers benefitting from massive cross-border transactions at the devastating expense of their Canadian counterparts.

Barlow and Campbell go on to describe how the Bank of Canada engineered an interest-rate hike that was the main factor responsible for driving up the value of the Canadian dollar, noting that: "the correlation between the signing of the free trade agreement and the implementation of the interest-rate policy is compelling. It is not hard to imagine the Canadian government, desperate for an agreement that Brian Mulroney had publicly staked his political future on, making a secret exchange-rate deal."

Any resemblance to trends in recent years in another U.S. neighbor could be a mere coincidence. But it so happens that, at the outset of the trilateral negotiations to extend free trade to Mexico, the U.S. Manufacturers asked the Bush Administration for assurances that any new agreement "seek to prevent exchange-rate manipulation for a country's competitive advantage."

The Canadian analysts conclude: "whether or not the Conservative government made a secret commitment to jack up the Canadian dollar, its high-interest/exchange rate policy has been deliberate. It has dramatically increased the pace of harmonization and restructuring and, in the process, is ravaging the Canadian economy. David Abramson, editor of the International Bank Credit Analyst, sees it as a deliberate strategy to discipline firms to cut wages and other costs - or fail, in such a way that the ones remaining are the ones that compete."

Is there a similar exchange-rate understanding between the governments of Mexico and the United States in the NAFTA? These governments should disclose any such commitment. Some analysts in the two countries have already pointed out that a massive devaluation of the Mexican peso would offset the advantages of tariff reduction or tariff removal in bilateral trade.

So When's the Next Bailout?

Let us ask ourselves again: can a devaluation in Mexico be avoided indefinitely? Mexico's current-account deficit reached U.S. $22.8 bn in 1992. It is largely being financed by external capital inflows, which can only be maintained with sky-high yields.

Although the Central Bank's reserves are still sizeable (around U.S. $20 bn, we are told), pressure on an overvalued peso is mounting. The Mexican government does not seem to want to devalue. The question is, to what extent is that position sustainable? The solution so far has been to "freeze" the economy, with higher unemployment and a multiplication of bankruptcies the result. Recession is the price to be paid in order to prevent devaluation.

The Financial Times, in its 12 May 1993 survey on NAFTA, tells us that "...the Mexican economy and political system is in a state of great uncertainty." It goes on to say that "the side agreements have extended the agony surrounding ratification." Along this line, officials at the highest level in the Salinas Administration have come to the United States to say that Salinas needs room to choose his party's presidential nominee. If by the end of the summer, it is argued, it is not certain that NAFTA will go into effect on 1 January, chaos will erupt: investors will divest from the Bolsa, capital flight will surge and the Mexican economy will collapse, bringing with it a maxi-devaluation of the peso and a massive exodus of workers to the United States.

Should a financial collapse break out in Mexico, it is highly likely that the U.S. Treasury would eventually have to face the question of whether to bail the Mexican regime out once again, much in the fashion of what it did after the debt crisis of 1982 and the stock-market crash of 1987. What is the point, however, of bailing out a government's economic program that has failed to meet the interests of its people? Massive amounts of financing from the international financial institutions have been injected into Mexico over the past three years, but little real development has been engendered. What we are talking about is not so much a problem of financing as one of policy. It would certainly be far better for the Mexican people if we were to address the question of the country's underlying economic strategy.

Policy Recommendations

In Mexico, macroeconomic beauty portrayed by the government's propaganda in the media coexists with microeconomic disaster. The production apparatus is in a shambles, and the quality of life for the vast majority of the Mexican people has deteriorated. The truth is that, at most, 20% of the population are true consumers -- the rest are fighting to survive. The REAL Mexico -- the one with over half its population living in poverty, an eroding middle class and an extremely wealthy elite -- is quite distant from the FORMAL Mexico pictured in the media. Just remember that after a decade of trickle-down economics, the migration of Mexican workers to the U.S. reached a record high in 1992.

With or without a NAFTA, economic policy in Mexico is approaching a dead end, because a model that relies on heavy capital inflows from abroad and results in a steep concentration of income and wealth is hardly a good basis for medium and long-term stability. Instead of imposing a sort of "market dictatorship" under which it curbs

inflation by enforcing a ceiling on wages and suppressing independent trade unions, manages the currency markets, and gives a high premium to financial speculators, the Mexican government should concentrate its efforts on a new strategy to foster production and sustainable development.

Mexico has had trade liberalization, but it can hardly be said that it has had export-led growth. What it is having now is import-led, insufficient growth. A sustainable trade strategy is not feasible without three vital elements: a) a competitive exchange rate; b) an industrial policy that designates areas of priority and allocates resources accordingly; and c) import controls (quotas, high tariffs) to protect strategic sectors. Recent World Bank research reported in The Financial Times ("Miracles beyond the free market," 26 April 1993) indicates that in Southeast Asia governments have intervened with these kind of policies more often and in a more systematic way than is acknowledged by Western free- traders. This strategy may very well translate into reduced U.S. exports to Mexico, but it would also bring with it healthier and more balanced growth to the Mexican economy.

It is also essential that interest rates be brought down to reactivate that economy, to bolster the purchasing power of the eroding middle class that is increasingly unable to buy the very goods they produce. A little more growth in exchange for an increase of two or three points in the inflation rate would not be out of place. This overall strategy would stimulate production, discourage speculation and reduce exchange-rate volatility. In addition, it would do far more in the long run than would NAFTA to save American taxpayers the cost of having to prop up and bail out the Mexican regime once again.

Thank you.

CARLOS HEREDIA is a Mexican economist with a graduate degree from McGill University in Montreal, Canada. He has been an adviser to small farmers' cooperatives in southeastern Mexico, and, during most of the last decade, worked for the Mexican Ministry of Finance. Since 1989 he has been Director of International Programs for the Mexican non-governmental organization, Equipo PUEBLO, and is active in a number of citizen coalitions, including the Mexican Action Network on Free Trade and the Citizens' Movement for Democracy. He is currently a Visiting Fellow at The Development GAP in Washingon, D.C.

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MEXICAN COMPETITIVENESS AND NAFTA[1]

Rudiger Dornbusch

Massachusetts Institute of Technology

Mexico is defending a patently overvalued exchange rate by high interest rates and an unyielding commitment to avoid depreciation and a resurgence of instability. How sustainable is the strategy, what are Mexico's options, and what are the implications for U.S. jobs? The worst outcome for the United States and for Mexico is a return of instability: for the U.S. it would mean a drastic decline of our exports and sharply higher pressure of competition from lower-yet Mexican wages and directly via migration. In Mexico a currency crisis would put in question the reforms and the progress, as yet quite incomplete, toward a stable, open society. There are two options to escape from the present predicament. One is a more rapid rate of crawl so as to prevent further erosion of Mexican competitiveness. The other is a rapid and sharp deceleration of inflation which contains the loss in competitiveness even if it does not immediately reverse the past losses.

The Mexican government has espoused that strategy and is reinforcing the credibility of that model with an independent central bank. We must welcome Mexico's timely attention to the problem because for us a stable Mexico is the best option.

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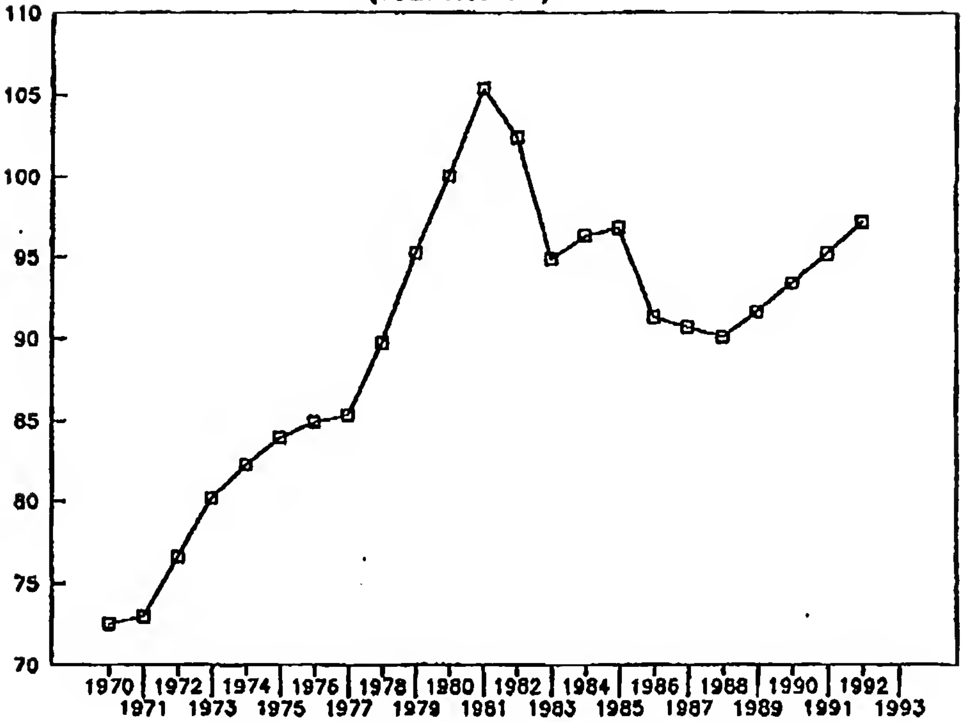
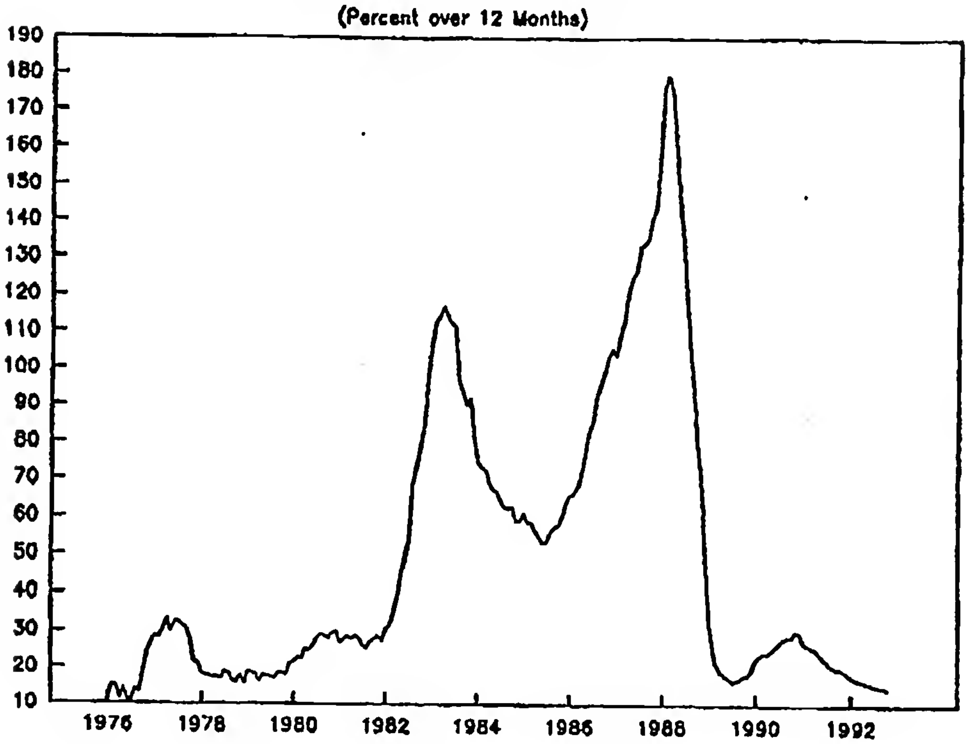
[1]Testimony before the Committee on Small Business, U.S. House of Representatives, May 20th, 1993.

MEXICO: PER CAPITA INCOME
(INDEX 1980=100)



MEXICAN INFLATION
(Percent over 12 Months)



SOME HISTORY AND THE CURRENT SITUATION

In the period from 1955 to the early 1970s, the exchange rate was fixed and the currency was freely convertible; public finance was sound, money was managed conservatively, and inflation remained moderate. Financial instability in Mexico dates back only to the mid-1970s, in the aftermath of the oil price increases.

The interlude of stability ended with the oil bonanza. Inflation jumped rapidly from 5 to 12 and then 25 percent. In 1975-76 the first devaluation in two decades disrupted financial stability. Inflation which had been less than 5 percent for two decades went double digit and never came back to this day.

Table 1 Mexican Macro History

Period	Inflation	Growth	Current Account[a]
1965-69	3.5	6.8	-2.2
1970-74	10.2	6.8	-2.8
1975-79	19.0	6.1	-3.6
1980-84	53.7	2.7	-2.1
1985-89	77.3	1.0	-0.4

[a]Percent of GDP

Even though inflation performance deteriorated, the period of high oil prices meant continuing strong growth. External borrowing which had already become significant in the early 1970s was kept up and in fact increased. Inflation increased, currency overvaluation became larger, capital flight started and then everything collapsed. By 1982, Mexico was

unable to roll its debts and went into moratorium followed by concerted lending.

The rest of the decade, with continuing debt problems aggravated by high world interest rates and domestic financial instability, meant low growth and massive real depreciation. Populism had its play for a brief while in 1982, including exchange control and bank nationalization. But then the pendulum swung massively in the other direction. For the past 6 to 8 years conservative reform has been underway. The current account deficit declined, much lower oil prices notwithstanding, the budget was balanced and inflation was brought down from a peak level of 160 percent reached in 1987. The adjustment took a heavy toll:

- real wages declined by at least 30 percent,
- per capita real GDP fell by 15 percent
- investment declined to only 17.6 percent on average in the period 1985-91.

But by 1989-1990 the first payoff on reform and stabilization was apparent. Growth increased substantially, even in per capita terms it became positive, inflation declined and foreign capital rushed in. But almost at the same time an exchange rate overvaluation started developing.

Table 2 Mexico: Current Economic Indicators

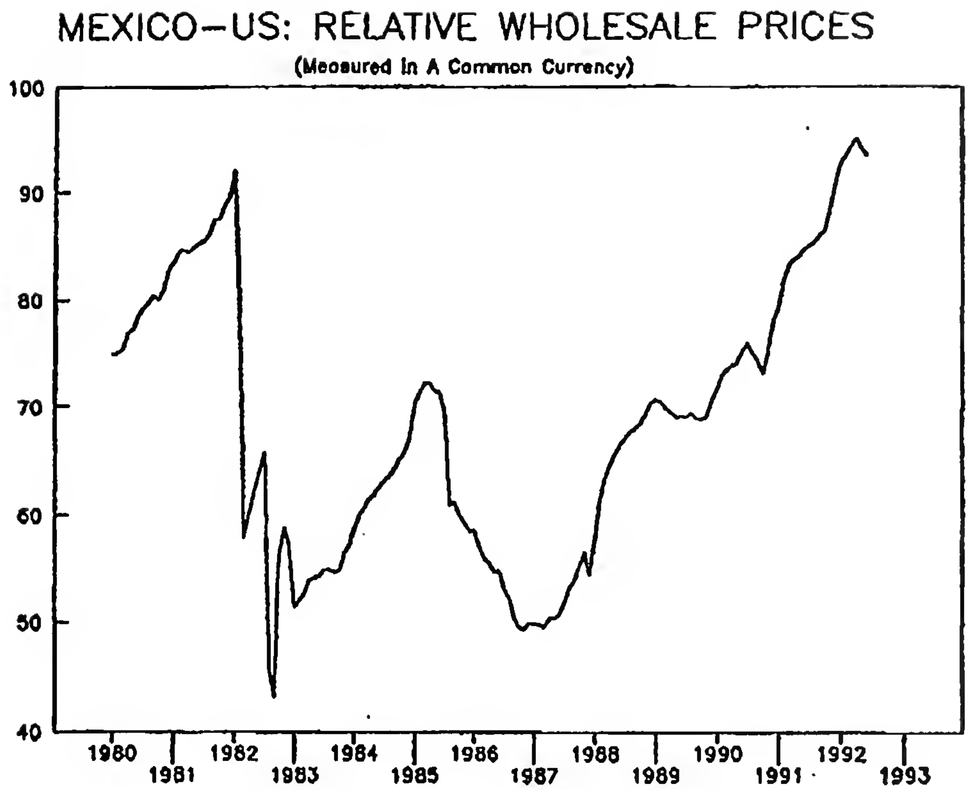
	1988	1989	1990	1991	1992[c]	1993[c]
Growth	1.7	3.3	4.4	3.6	2.7	3.0
Manufacturing	3.2	7.2	6.1	4.0	1.8	
Inflation	114.2	20.0	26.7	18.8	11.2	7.0
Budget[a]	-3.6	-1.7	1.8	2.7	2.9	2.1
Current Acc't.[b]	-2.4	-3.9	-7.1	-13.8	-22.8	
Import Growth	36.7	21.3	18.8	16.6	12.3	9.1
Export Growth	5.8	2.5	3.5	5.1	2.2	4.6

[a]Operational budget as % of GDP, excluding debt reduction and privatization. [b]Bill $US [c] Gov't forecast
Source: BdM

At present growth is still in the neighborhood of 3 percent--not Asian growth, but also not terrible. Interest rates are far too high on the lending side, especially for medium sized Mexican firms. The situation needs an answer and the new disinflation strategy may well offer one.

THE PROBLEM

The large deterioration of the Mexican trade balance and current account raise the question whether the deficit is sustainable and can be financed. The trade balance showed a surplus in the early 1980s, but by now comes to a deficit of close to $24 billion at an annual rate. The current account, as a percent of GDP reaches now 5 to 6 percent the same size as just prior to the debt crisis.


MEXICO–US: RELATIVE WHOLESALE PRICES
(Measured In A Common Currency)
100
90
80
70
60
50
40
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993


MEXICO: TRADE BALANCE
(Billion $US)
20
15
10
5
0
-5
-10
-15
-20
-25
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993

Table 3 Import Increase
(Bill. $US)

	1986	1991
Imports	12.4	38.2
Consumer Goods	0.8	5.6
Intermediates	8.6	24.1
Capital Goods	3.0	8.5

Source: BdM

There are four separate reasons for the large trade deterioration.

• Trade liberalization: Mexico was almost a closed economy. And if it was not quite that, the payments crisis of the early 1980s did the rest. Quotas abounded and tariff rates were as high as 100 percent. Import permits were a routine requirement.

Over the past 6 years trade has been liberalized on a unilateral basis. Table 4 shows in one way the extent of liberalization. But a more tangible way is, of course, to look at the massive deterioration of the trade balance. Strong import growth, not negative export performance, was the source for trade deterioration.

Table 4 Mexican Trade Restrictions
(Percent)

	1985	1989
Import Licence Coverage	92.2	22.3
Reference Price Coverage	18.7	0
Maximum Tariff	100.0	20.0
Average Tariff	23.5	12.5

Source: USITC

If trade problems are to be avoided, trade liberalization should be accompanied by real depreciation. The opening on the side of imports proceeds at a far more rapid pace than any beneficial effects on the export side. True, better intermediate goods, for example, may help make exports more competitive and better machinery may put some industries in a position to produce at quality levels appropriate for demanding outside markets. But these adjustments are far more time consuming than the immediate response on the import side. Moreover, with financial constraints and poor growth, importing is a far easier way of pursuing a modernization strategy than to try and replicate foreign goods for the home market.

In sum, trade liberalization creates a presumption that real depreciation is appropriate; if it does not happen there is overvaluation.

• Lower Oil Prices: Except for a brief upward flurry during the Gulf War, oil prices in dollars are far below the levels of the early 1980s. As a result, Mexican oil export revenue in 1991 were only half those of 1984.

• Stronger growth: The increase in demand naturally spills over into increased imports. This effect is more important in that low levels of capacity in Mexico, because of many years of low investment, reduce the ability of firms to meet increased demand.

Higher demand growth also translates into imports because of higher investment to expand capacity and increasing levels of intermediate goods imports.

• Overvaluation: Real appreciation must certainly also account for some of the trade deterioration. As Figure 3 shows, Mexican wholesale prices in dollars relative to those in the United States have increased since their bottom in 1986 by 50 percent. For the moment we focus merely on the increase without passing judgment on how much is overvaluation. The mere fact of an increase ought to worsen the trade balance.

COUNTER ARGUMENTS

There are several arguments in support of the view that Mexico's real exchange rate, all appearances notwithstanding, is not really overvalued. The first argument compares Mexico in 1986 and 1992. In 1986 Mexico was on the ropes; access to the world capital market had been cut off, inflation was extreme, reforms had barely begun and capital flight remained a serious issue. In this precarious economy which was basically under siege, the real exchange rate just had to be rock-bottom low.

Consider next 1992: reforms on an extraordinary scale have moved Mexico to the forefront of high performance in policy around the world, world capital markets are therefore Mexico to borrow with ratings upgraded steadily; capital is flowing in at rates that are almost troublesome. The stock market in dollars increased by 400 percent over the 1988-91 period. This is an economy where there is a reform bonus to be collected and that means real appreciation. In fact, the argument can be made that it is the inflow of capital that is the driving force of inflation and real appreciation. Here the return to voluntary lending is equivalent to a

capital account opening. The argument is entirely correct for the case of Mexico, just as it was correct in Spain. The only question is how much of a real appreciation is warranted.

Another argument comes into play, again drawing on the analogy with Spain. The forthcoming ratification of Nafta creates incentives for U.S. capital and capital from other industrialized countries to be invested in Mexico. The financing of external imbalances is thus at best a short term problem,-- from here to fall of 1993 when Nafta is completed. Once direct investment flows come on stream there is medium term financing which bridges the gap between modernization that is underway and the ultimate payoff in a strong export base. The argument is rounded off by highlighting that a significant portion of the trade imbalance reflects investment goods so that at best there is a mismatch between the hot money funding and the cool capital formation.

A further argument in support of the status quo runs this way: There is now a budget surplus in Mexico. A country with a budget surplus, in some deep sense, cannot become vulnerable to financial instability. The external deficits are private, the government is managing public finance very conservatively.

In this view, there is no question that normalization must yield <u>some</u> bonus in terms of real appreciation. The central question is when it should be collected. The risk of the current strategy is that it is collected as a prepayment, before reforms fully carry their benefits and while trade deficits are large by historical standards and growing. The

risk of the present strategy is that Mexico could be caught with large deficits and no financing, being forced into abrupt and massive real depreciation or the reintroduction of severe trade controls. Relying on the farsightedness of money markets and foreign portfolio investors seems a precarious strategy.

In summary, the exchange rate is overvalued <u>and</u> on current policy will become more overvalued over the next year. The current pace of the crawl-- about 4 percent per year-- falls far short of the inflation rate which, although declining, is still running above 7 percent. Inflation convergence will occur only after yet another 5 percent loss in competitiveness. Moreover, there is no automatic mechanism in place to reverse the loss in competitiveness. That of course implies extra vulnerability. and is reminiscent of Chile in the late 1970s.

POSSIBLE POLICY RESPONSES

We next explore several strategies of how to deal with the overvaluation problem and move to a stable financial system.

• <u>Sit tight, don't blink</u>: This option recognizes that doing anything different from what is being done is politically difficult and therefore not acceptable. In this perspective, the problem is minimized by appealing to the fact that unit labor costs in the maquila industry are increasing at no more than the U.S. pace, that CPI based real exchange rate comparisons are inappropriate because many subsidy removals that affect consumers do not affect competitiveness. The perspective also

highlights the imminent favorable effects of a Nafta conclusion, specifically major capital inflows in the form of direct investment.

The basic posture here is to start from the end -- nothing can be done -- and proceed from there to rationalize that nothing need be done, really. The position is locally stable since the public deeply believes that the government would hate to do anything. Therefore, until a major focal point occurs, the situation can evolve as it has over the past year without the risk of a run.

There is a powerful line of argument that seeks to underpin the do nothing strategy by institutional mechanisms: specifically, the creation of an independent central bank. Italy's example shows that the shift to a far more independent central bank held off the crisis for a while because real interest rates were raised to the sky, but it did not prevent the run.

• Be tougher, make a recession. This position does recognize that there is a problem and that something has to be done. But because inflation is accepted as the overriding priority, the only strategy left is to slow down the economy forcefully by a tighter fiscal stance and by tight money. Growth has already come down to only about 2-3 percent and 1993 will have that and not much more. That rate, of course, lies even below the rate of labor force growth and thus is far away from a growth sufficient to avoid rising unemployment. If the Okun's law estimate in the U.S. is a 2.5 percent growth so as to keep unemployment constant, the equivalent number in Mexico is 4 percent or even higher.

This strategy aborts the very implementation of modernization and reform. Investment will not pick up, political popularity of reform will fade and by the time the election comes, there is no assurance that all is well. The calculation that there will be a substantial cushion for a sharp growth spurt in 1994 may turn out to be wrong. In fact, the strategy may run into conflict with increasing uncertainty about the sustainability of the parity; increasing real interest rates even beyond current levels will then create far more of a crunch than is now expected.

• Maxi-Devaluation, the last one. For many observers outside Mexico, devaluation UK style is the obvious answer. Devalue the peso by say 20 percent, declare that this is the very last time, and enjoy prosperity for ever more. In fact, to enhance credibility, accompany the devaluation by a major fortification of the monetary institutions: an independent Central Bank, a constitutionally fixed parity, etc.

The trouble with this strategy is that it will wreak havoc in financial markets and in the labor market. In financial markets it has come to be excepted that the government will not devalue -- if there are problems, the pace of the crawl picks up, but no discrete parity changes. Reversal of this established mode would take the financial market back to the mid-1980s and it might prejudice the newly gained access to world capital markets.

In the labor market, a devaluation would cause conflict. Labor has cooperated in a number of pactos and by now there is clearly some pacto-fatigue. A devaluation would be a confrontational breach of

arrangements that might well lead to political mobilization and from there to increasing uncertainty about the course of capital flight and about inflation.

• Increase the pace of the crawl. This strategy is condemned as being out-and-out inflationary. The most adamant opposition asserts that the real exchange rate cannot be changed by a faster crawl --inflation will simply pick up and that is that. Of course, one cannot defend that view and at the same time applaud the recent shift of the crawl from 2 to 4 percent per year.

The strategy of a faster crawl would accept an increase of inflation to 15-18 percent as the price for gaining competitiveness and the price for avoiding a recurrence of the exchange rate and social crises of the past election years. The pace of the crawl; would be stepped up immediately to 22 percent per year, declining slowly toward 17 percent over 18 month. With current inflation near 10 percent, the real exchange rate would start depreciating. Of course, inflation would gradually rise--more so the less success there is in containing wage adjustments. Over 18 months the depreciation and inflation rates would converge somewhere around 17 percent. That unfortunately represents a high level of inflation, but it is far better than a collapse of the exchange rate also followed by inflation but quite possibly also by a loss of control.

Inflation is a very serious problem and the authorities are right to have taken it down to less than 20 percent. The art of inflation fighting is to know when to stop. A wise U.S. senator when asked

for counsel advice on what to do about the unending Vietnam war advised: declare victory and get out.

Mexico's authorities might reassess their priorities and shift to a model where growth comes first, but inflation is firmly contained below a 20 percent barrier. That is possible, as Chile's example of the past decade shows quite convincingly.

- A Drastic Disinflation. The last option, now apparently underway, envisages an incomes policy-based drastic reduction in inflation. Last december the pacto introduced a 9.9 percent wage ceiling. Inflation rates have been coming down to only 7.5 percent at an annual rate in the most recent data. Yet another pacto round, if it should prove politically possible, could drive inflation down to U.S. levels by the end of the year.

Rather than running the risk of inflation with an accelerating pace of depreciation, the Mexican government is opting for incomes policy and making the last mile. The strategy is risky, but if the external environment including the developments on NAFTA are favorable, Mexico might by the end of the year have established a credibly stable money. There can be no better support for a long term growth policy. The risk of the strategy, as seen in Europe recently, is that overvalued currencies are endemically vulnerable.

IMPLICATIONS FOR THE UNITED STATES

The United States has benefited significantly in the past few years from Mexico's trade opening and from its real appreciation. In the

period 1984-87 our trade balance averaged a deficit of 5.5 billion and today there is a surplus of 4.1 billion. The shift of 9.6 billion translates unquestionably into a net U.S. job gain. To quantify the gain we can use the rule of thumb that a million dollars extra exports creates 33 extra jobs as proposed by the Washington-based Economic Policy Institute. On that reckoning, 320,000 extra jobs have been created as a result of the Mexican reforms, trade opening and real appreciation.

Table 5 U.S. Trade Balance With Mexico
(Billion $US)

	Total	Nonoil	Maquila
1984	-6.0	0.7	-1.2
1985	-5.5	1.5	-1.3
1986	-4.9	0.5	-1.3
1987	-5.7	-2.2	-1.6
1988	-2.6	0.2	-2.3
1989	-2.2	1.8	-3.0
1990	-1.9	2.9	-3.6
1991	2.1	6.4	-4.1
1992	4.1		-4.7

Source: U.S.Dept of Commerce and Hacienda, Mexico

There is every expectation that a stable, growing Mexico will do far better for us in the future. Major sectors remain to be opened and create export and employment opportunities for the United Stares. The data of the past few years make a parody of the suggestion that Mexico is too poor to buy from us. Once investment gets underway, our capital goods industries will be major beneficiaries as our consumer and intermediate goods industries already are.

The scare about jobs going en masse to Mexico has absolutely no basis in the experience of the past few years. Trade-related net job creation has favored the United States. The evidence in support of a massive job loss, specifically the material Jobs at Risk submitted in Congressional Testimony by Ross Perot does not deserve any attention. It is designed to scare and any serious research effort is decidedly absent.

For the opposition, NAFTA represents the very incarnation of everything that is wrong in the American economy. With concern for jobs at the top of the agenda, the very idea of free trade seems shocking. How could free trade with a low wage country mean anything but a massive loss of jobs -- Ross Perot's "great sucking sound" as jobs go south.

The hysteria over NAFTA and its alleged destruction of American jobs is absurd. Mexico is a very small economy compared to our own. Mexican GDP is some $300 billion compared to $ 6,000 billion here. If Mexico had 1/100th of the success in taking our jobs that NAFTA opponents predict, that country would explode in growth and burst at the seams with prosperity.

All the hype notwithstanding, NAFTA merely puts the finishing touches on a basically open trade relation between the United States and Mexico. We have been open to competition from abroad for decades. There is nothing new in having to compete with the rest of the world, low wage and otherwise. And where under the agreement trade is opened in very uncompetitive industries, an extraordinary transition period of up to 12 years softens the blow.

NAFTA opponents emphasize the experience of the maquila industry which has a special customs regime. In this rapidly growing industry U.S. firms have labor intensive assembly work done by "cheap" Mexican workers. The industry is now exhibit #1 of what will become a pattern. But note this: after a decade of rapid growth, Mexican value added in these plants amounts to a mere $4.7 billion. That compares with a U.S. manufacturing GDP of $1,000 billion. Its hard to see how Mexico is doing us in. In fact, if the assembly work were not done in Mexico, where would it be done? It is entirely plausible that in many industries jobs would disappear in the North because the entire production would go offshore.

NAFTA opponents conjure an image of dramatic job losses and wage cutting as Mexican competition is turned on by imports into the U.S., plant relocation and massive investment by our firms across the border. But the last few years, following the Mexican opening of its economy and a semblance of prosperity suggests a very different image. No doubt there have been plant relocations toward Mexico but if anyone has kept a tally, the job losses from those relocations make up far less than this immediate and tangible gain.

Mexico has not even started investing and growing. Over the coming decade, Mexican demand for our goods is certain to expand at healthy rates as their economy increasingly takes advantage of access to our goods. Mexico is too small to ruin us, unfortunately it is also much too small to make us rich. But in the meantime, job creation runs squarely in our favor whatever the opponents say.

NAFTA is good economics for both U.S. labor and business. It is also good foreign policy. Prosperity in Mexico is the best way to assure that modernization and political opening will take hold. Moreover, a prosperous Mexico will help stem migration and spread some growth to Central America where our economic and political record has been very poor.

If NAFTA goes, so does all that and more. Mexican reform and financial stability will collapse, but competition will not go away. On the contrary, with even lower Mexican wages, it will become much fiercer. But the costs go much further. A defeat of NAFTA in the Congress would be a dramatic setback for trade policy in the world economy. GATT would be the next target and soon the open multilateral trading system would be gone. The U.S. is a prime beneficiary of that system (whatever its flaws). Jobs would be lost en masse; economically and politically we would be on record as having lost our resolve and our ability to lead the world.

A stable Mexico, without currency experiments, and a NAFTA with good side agreements and a significant domestic adjustment support program represent a win-win package for the United States and for Mexico.

May 1993

THE GREAT ASIAN REALIGNMENT

Rudi Dornbusch
Massachusetts Institute of Technology

Over the past two decades and more, Asia has been enjoying an extraordinary growth experience. A virtuous cycle of high rates of investment and innovation, high growth rates of output and real wages, and high rates of saving combined with macroeconomic stability yielded record growth rates almost without interruption. And that process keeps going on. Japan's recession is but a momentary setback in a picture of stunning growth.

Table 12 Asian Economic Growth

	1971-80	1981-90	1991-93
Asian Nics	9.0	8.8	6.9
S.E. Asia	7.7	5.5	6.7
China	7.9	10.1	9.2
Japan	4.5	4.2	2.7

Source: Asian Development Bank and IMF

Widening access to the world market and a dynamic export sector have been key factors in the growth record of these economies. For at least a decade. large trade surpluses have also been part of the story. By way of envy or just curiosity, the question arises whether the performance unduly benefited from export-led growth, at the expense of the rest of the world. Specifically, of the many explanations for Asia's surpluses, has systematic currency undervaluation been an important factor? And if so, is there likely to be a correction soon? We will argue that the answer to both questions is affirmative.

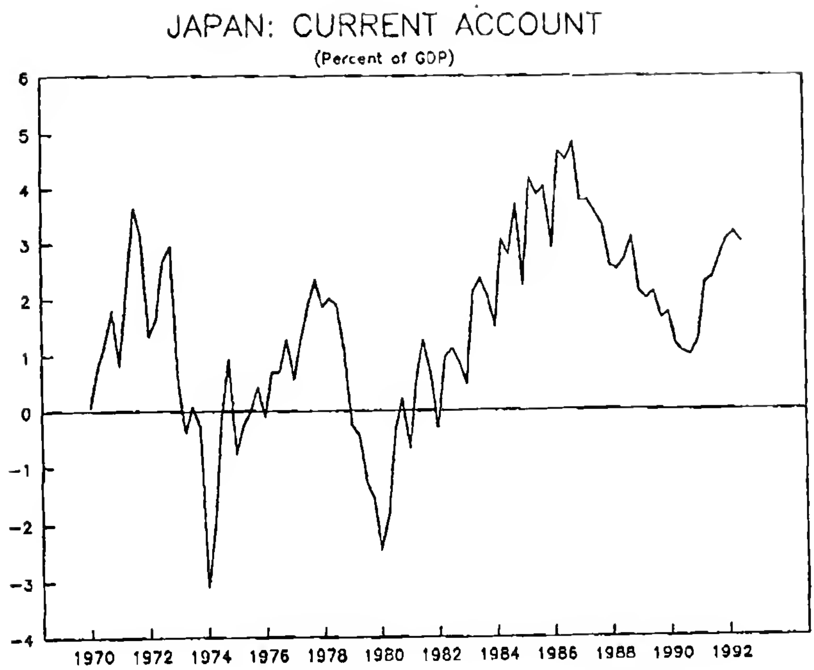
Explanations for the Surpluses

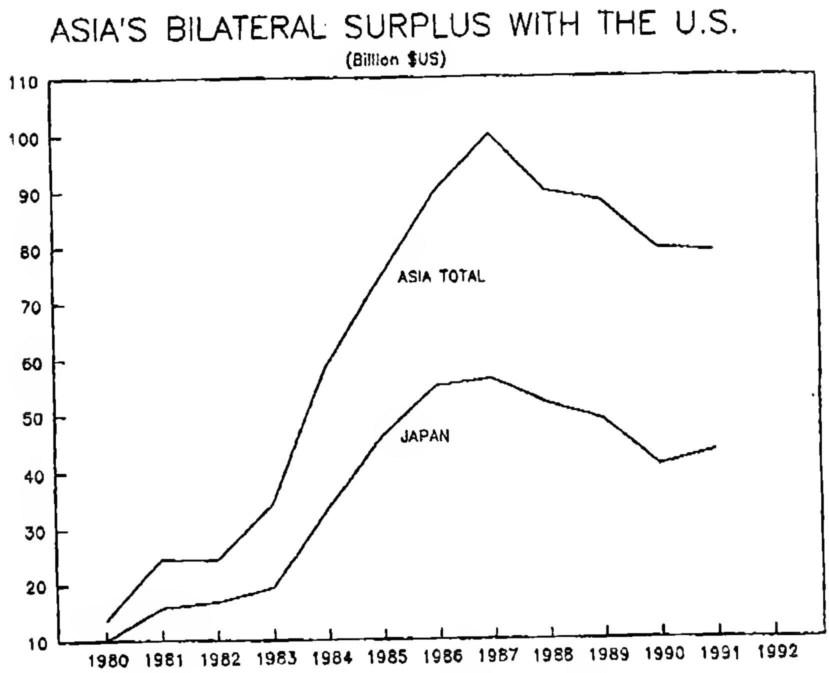
The first point to make is that Asia has been running surpluses with the world for more than a decade. Moreover, bilateral surpluses with the United States have been growing. On preliminary indications the 1992 numbers, which are not yet available, promise to show record levels.

Asia's surpluses have received a number of explanations:

• Asia saves at a high rate, the rest of the world and specifically the United States does not. External imbalances are reflections of domestic saving-investment balances. Countries which save more than they invest at home will have surpluses and countries which save (including the government) less than they invest have deficits. In this perspective Asia's huge saving rates show easily in their surpluses and the U.S. deficits quite obviously translate into deficits. Macroeconomists like this view-- the twin deficit story has appeal because it comes straight from accounting.

Of course, one can turn the story around and ask why the U.S. has big budget deficits. The weak economy is surely a reason for the deficit and for an unwillingness, until recently, to tackle it. Therefore deficit stories cannot be quite the end of the discussion. The same is true on the Japanese side: if Japan's government pursued a more reasonable fiscal strategy-- investing in a major downturn in public works-- there would be less of a tendency to play beggar-thy-neighbor strategies via huge surpluses.


JAPAN: CURRENT ACCOUNT
(Percent of GDP)
6
5
4
3
2
1
0
-1
-2
-3
-4
1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990 1992


ASIA'S BILATERAL SURPLUS WITH THE U.S.
(Billion $US)
110
100
90
80
70
60
50
40
30
20
10
ASIA TOTAL
JAPAN
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992

• Asia has surpluses because the playing field is tilted in their favor. Many economies remain quite closed, by whatever means, but access to open world markets is eagerly exploited by Asia's export industries. Surpluses, in this perspective, reflect predominantly the differential openness of markets. This view is popular with politicians and economists give it little, possibly too little relevance.

Evidence in support of this view includes the very closed nature of the Japanese economy. The ratio of non-oil imports to GNP is lower today than it was in the 1960s. The ratio of manufacturing imports to GNP is not very different from what it was 30 years ago. And, of course, import penetration is far, far below the standards of any industrial country both in terms of its level and its trend. In other industrialized countries import penetration has doubled or tripled, in Japan it has barely moved from a minimal level.

Table 13 Japan's Imports
(Percent of GDP)

	Non-Oil	Manufactures
1961-70	7.9	2.0[a]
1971-80	7.2	2.1
1981-90	6.4	2.4
1991	5.9	2.9
1992	n.a.	2.6[b]

[a]1965-70 [b]1991:4 to 1992:3

If Japan is closed, the same cannot be said of all Asian economies. Some have practice outright openness. Others, such as Korea have gradually opened but reached in the process a very remarkable level

of exposure to world competition. For example, In Korea non-oil imports corresponded in 1991 to 26.5 percent of GDP.

• Quality, marketing, and service have also drawn attention as a separate explanation. The United States, it used to be said, was behind in every dimension. Turned toward finance and short horizons, with engineering and private commercial research at a discount, U.S. innovation was inadequate and a focus on the consumer was lacking. No surprise then in poor export performance and stunning growth of imports.

• A further explanation should occupy a central place: exchange rates. Over the past decades Asia has been catching up with the United States. That catchup process should ultimately translate into significant currency appreciation, but that has not yet happened. In fact, with the exception of Japan, Asian currencies today are at their 1980 levels or even more competitive then at the time. And even for Japan the moderate real appreciation in no way offsets the enormous gain in market position of the past few decades. Unchecked by appreciation, the gains in manufacturing performance translate directly into export-led growth and trade surpluses.

Table 14 Real Exchange Rates in Manufacturing
(Index 1980-82=100, data show March 1993)

Japan	129.3	Malaysia	84.5
Taiwan	89.1	Thailand	78.0
Hongkong	121.2	Indonesia	56.3
Singapore	88.1	Philippines	103.1
Korea	76.9		

Source: Morgan Guaranty

What Comes Next?

There are three reasons to expect a major appreciation of Asian currencies. First, in the current situation of world weakness the evergrowing Japanese surplus is an offense. In 1985, the U.S. Congress in an unanimous joint resolution called on Japan to reduce its trade surpluses. Today's surpluses are as large and the sympathy for Japan's exporting unemployment can be found nowhere, neither in the United States nor in Europe. As pressure for trade action against Japan increase, currency appreciation is gar easier option for the Japanese officialdom than a rapid opening of their economy.

The counter part of an appreciation would, of course, be a narrowing of the trade surplus and a reduction in demand for Japanese goods. In Japan's current situation that calls for more fiscal stiumulus to avoid a deepening of the slowdown. That is unattractive to the Ministry of Finance pundits, but on strictly economic grounds there is no problem. The budget surpluses are large and the debt to GDP ratio is small. No country is better placed for Keynesian policies than Japan. Rather than tire ourselves encouraging Japan to expand, we ought to just push up the Yen and leave the MoF with the predicament of suffering a recession or offering a Reagan-style tax cut. Japan's debt ratiuo in the mid-80s was above 40 percent, now it is already down to 36 percent. After all, what is wrong with tax cuts when a country can afford them? What is the use of surpluses if not to use the fiscal leeway in a tight spot?

The second reason for appreciation is less immediate but as important. Asia is experiencing a unification project just as occurred in

Germany. Coastal China, Vietnam, North Korea and Siberia are moving toward the market. Asia money, capital goods technology, management, and market outlets are the engines of that process. As this process goes forward, Asia's advanced economies from Hongkong to Taiwan, Korea and Japan will run trade surplus with the transition economies and they will be financed by direct foreign investment flows and portfolio capital.

The increased trade will in time create a boom in the advanced economies. As that boom comes, just as in Germany, real appreciation is inevitable. That can come in one of two ways: domestic inflation or currency appreciation. The preferred way, of course, is a rise in all the Asian currencies in unison relative to Europe and the dollar. The reason to take this prospect seriously is not only the fact that it is already underway. More so, it is the sheer size of this transition region-- far larger in fact than Eastern Europe and the former Soviet Union. China is already the second largest economy and, at the growth rates we are seeing today, it won't take much time for the giant to be #1.

The third reason for Asian appreciation is to be found in the United States. The Clinton budget program will bring about a major slowdown of demand in the U.S. economy. The phase-in assures that the economy has a chance to adjust to the budget cuts without recession, but what is the adjustment? Lower longterm interest rates will help increase investment and a far lower dollar will turn around our external trade. While there may be some depreciation relative to Europe, the brunt of our gain in competitiveness will have to be relative to Asia. We need trade

surpluses, they can shift their surpluses to the Asian transformation economies. A major currency appreciation will help make that adjustment smoothly.

Sceptics will ask: can exchange rates do the trick? Where is the evidence that a stronger Yen will mean smaller Japanese surpluses? In the past, major changes in the Yen have not had a stark impact on Japan's trade? An important reason was the way Japanese companies operate. Rather than rapidly adjusting prices (and hence the trade balance) the companies would pursue their long term strategies even at a loss. Their captive financial institutions would finance the long horizon strategies. Today the financial system is on the ropes. They can no longer accommodate a extended adjustment to a tight exchange rate situation. Accordingly, Japanese firms would be forced to work more with prices and that is precisely what one expects in the aftermath of currency realignments.

That leaves one more question: how to accomplish the move in the Yen? To accomplish a major Asian appreciation is in the first place a political decision. Countries such as Hongkong who peg the dollar would have to move just as much as Japan where the exchange rate is closely managed by the authorities. A good move on the Yen could come about if Europe and the United States made it known that just this is their agenda for the next summit.

A major currency realignment such as the one discussed here is not without precedent. During the postwar period Europe enjoyed export-led growth, taking advantage of an increasingly undervalued currency. Germany

(like Japan today) had occasional and minor realignments, but the group held on to an undervalued currency despite repeated U.S. appeals. Only with the transition to floating in the early 1970s was the situation rectified with a 30 percent U.S. depreciation. Just the same is necessary now in our currency relations with all of Asia.

Attention rightly focuses on opening up Japan, but the cumbersome diplomacy focuses on only one instrument, the administrative piecemeal opening of one sector or another. Because there is a lot of work to be done in breaking down Japan's closed economy, we should use all tools available for the task. It would be a mistake to forget that currency depreciation can render sweeping assistance in that effort. Moreover, adjustment is as importnt for all of Asia as it is merely for Japan. One more reason there to use a broad and sweeping currency appreciation.

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THE MEXICAN PESO

STATEMENT OF JEROME I. LEVINSON
ECONOMIC POLICY INSTITUTE

BEFORE THE SMALL BUSINESS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

MAY 20, 1993

COMMITTEE ON SMALL BUSINESS-HEARING

CONCERNING THE MEXICAN PESO, MAY 20 1993

STATEMENT OF JEROME I. LEVINSON

Thank you for your invitation to testify this morning.

The Hearing and the subject matter are particularly timely. The parties to the North American Free Trade Agreement (NAFTA) are negotiating supplemental agreements dealing with worker rights, environmental considerations, and import surges. Once completed, these negotiations will enable the Clinton Administration to place before the Congress the implementing legislation, presumably including the supplemental agreements. And you, the Congress, will then be called upon to make a judgment:is the NAFTA good, bad or indifferent for the United States? Do the supplemental agreements go far enough, or too far in safeguarding both the environment and worker rights? These and other issues will be principal points of debate.

I would like to suggest to you, however, that there is a specter haunting your consideration of the NAFTA, which will increasingly come into play, particularly if the tide seems to be running against the NAFTA in the Congress. The argument will be made that a rejection of the NAFTA will create a financial crisis in Mexico with dire consequences for President Carlos Salinas de Gortari and the governing party, the Institutional Revolutionary Party(PRI). The reforms initiated by the Salinas Government, privatization of state run enterprises, the opening of the

economy to imports and foreign investment, it will be argued,. are all in jeopardy. Even, it will be urged, I dare say, that United States political relations with Mexico will be imperilled. The opening salvo of this coming onslaught was sounded in the Washington Post this past Sunday, May 16th on the front page of the Business Section of that day's newspaper.

This argument, I suggest, is the real issue of this Hearing. There is a very real risk that rejection of the NAFTA by the Congress will set off a financial crisis in Mexico, but the risk of that crisis is a risk which arises as a consequence of the development strategy followed by Mexico, a strategy which has been acclaimed in this country by business and financial groups, and the Bretton Woods institutions, the World Bank and the International Monetary Fund (IMF), and the Inter American Development Bank (IDB). The peso issue which you have posed in technical terms cannot be divorced from that strategy and its consequences. I hope that you in the Congress will not be panicked into an ill considered judgment on the NAFTA on the basis of an ill considered strategy.

Mexico is running a current account deficit estimated to be $23 billion in 1992, "unusually high for a nation of Mexico's size." (Louis Uchitelle, "High Mexican Interest Rates Are Luring Wall Street Cash", New York Times, April 22, 1993). When petroleum prices were higher than expected, Mexico very sensibly did not squander the windfall, but set some part of the unexpectedly high petroleum price aside in a reserve fund. This

has provided a financial cushion, which has enabled the government to partially fund the current account deficit.

But the cushion has not been large enough; it has therefore had to rely on attracting foreign capital, primarily from the United States. Some part of this capital represents the repatriation of Mexican flight capital, which had previously sought refuge in the United States. A significant part of this flight capital now seeks a higher interest rate than it can earn in the United States or other international capital markets. Mexican government bonds offer rates at around 16-17 percent. Mexico is also perceived as a relatively safe haven for capital, not least because of the perception that the U.S. Congress will pass the NAFTA, thus consolidating Salinas's political ability to dictate a successor sure to consolidate the economic changes he has initiated.

This is also capital which is highly sensitive to perceptions relating to adverse political events, such as the possibility or probability that the Congress will fail to approve the NAFTA. The volatility of this source of capital was illustrated recently when the Director of the Budget, Leon Panetta, gave it as his judgment that the NAFTA could not pass the Congress; within hours, the Mexican stock market plunged 30 percent, only to recover when Clinton Administration officials rushed in to stop the financial hemorrhage by assuring that they did not share Panetta's judgment.

The Council of the Americas observes that "prospects of

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NAFTA implementation have already generated strong anticipatory effects, with capital inflows to Mexico estimated at about $18 billion, of which about $5 billion was foreign direct investment." (Council of the Americas, Washington Report, Spring, 1993, p 2). The same report notes that, "[r]ejection of the NAFTA would also probably cause much of recent capital inflows to leave Mexico."(Id).

That foreign direct investment (FDI) is drawn to Mexico to take advantage of low wages, the proximity to the United States and the prospect of a free trade area between the two countries: "...[T]o maintain the low wages that draw American companies to Mexico, President Carlos Salinas de Gortari has gotten commitments from business and union leaders to limit raises. It could be years before the gap with American wages narrows significantly..."(Louis Uchitelle, "America's Newest Industrial Belt", New York Times, March 21, 1993). Although real wages have recovered somewhat, particularly for skilled workers, workers are nowhere near recovering the decline in average real wages they suffered in the 80's. (Sidney Weintraub, the Economy on the Eve of Free Trade, Current History, February 1993, p. 68).

Mexico has been able to hold the line on wages, in large part, because Mexico's labor union leadership is beholden more to the governing party, the PRI, than it is to the workers it nominally represents: "For the moment, the PRI apparatus is holding the unions in check and that permits the continuation of a price and wage restraint pact with them and the employers--

which is the basic pillar of [President Salinas's] economic strategy."(Information prepared by the United States Embassy in Mexico City in Reply to Questions Posed About Mexican Labor Standards by Rep. Sam Gibbons (Unclassified). Commenting on the role of the Mexican Minister of Labor, Arsenio Farell Cubillas (The Labor Ministry is formally known as the Secretariat of labor and Social Welfare), the U.S. Embassy further observed, "Farrell has maintained his reputation as a formidable labor opponent. He has maintained pressure on the labor sector in an effort to hold the line on wage demands...Farrell has not hesitated in declaring a number of strike actions illegal, thus undercutting their possibility for success. These and other successful confrontations with unions have generally served to minimize the gains of labor activism." (Mexican Labor Trends, Annual Labor Report for Mexico from 1988 to mid-1990, prepared by the United States Embassy in Mexico City, Mexico, pp. 12,13 (Unclassified)).

Mexico has sought to finance its current account deficit by (a) enticing short term capital by offering a high interest rate environment, which is particularly attractive in contrast with available current U.S. interest rates and (b) more permanent FDI by offering a low-wage relatively well-trained labor force, and a wage policy which is enforced by the strong arm tactics of the Ministry of Labor. The technical question you have posed as to the future prospects of the peso, inevitably, leads back to the Mexican development strategy. They have bet the rent money, the house and the family jewels on the passage of the NAFTA. In so

doing, they have trapped themselves and now seek to trap you, the Congress, and the Clinton Administration in a series of contradictions which it may not be possible to reconcile.

As Louis Uchitelle observed in the New York Times, Mexico seeks to attract U.S. FDI by offering a low-wage environment and stable labor relations. As the U.S. Embassy in Mexico City candidly notes, that low wage/stable labor environment is enforced by a Labor Ministry, which has not hesitated to use strong arm tactics against recalcitrant workers. To its great credit, the Clinton Administration has determined that those tactics are not acceptable to it. That is the reason, as President Clinton's October 1992 Raleigh, North Carolina, speech detailed why candidate Clinton stated that he could only support NAFTA if accompanied by a meaningful side agreement that addressed the worker rights issue in Mexico (and environmental enforcement).

To be meaningful, the supplemental agreement must assure that Mexican workers can organize independent trade unions that can defend their interests, which is not now the case. And it must cast a chill on the present intimidation of workers by Mexican authorities, to which the U.S. Embassy alludes. To the extent that the supplemental labor agreement achieves these objectives, it also inhibits the Salinas government (and its successor) from using the tactics which have assured the foreign (and domestic) companies of the secure low-wage environment, that is attracting them to Mexico. A meaningful supplemental labor

agreement thus strikes at the centerpiece of the Salinas government economic strategy.

As this truth sinks in, pressure will grow for Mr Kantor to ease up in his demands for a meaningful supplemental labor agreement (and to ease up as well on the content of the environmental agreement). To the extent he gives in to these considerations, however, he jeopardizes, rightly so in my opinion, support for the NAFTA in the Congress. And he increases the perception that the NAFTA may not be able to gain the necessary support in the Congress. If that perception gains ground in Mexico, there is almost certain to be a new flight of capital of some serious dimension.

The situation is further compounded by the agreement that Mexico has negotiated with its commercial banks, which reduced the nominal amount of the debt owed to these banks. As part of that agreement, Mexico agreed to guarantee repayment of principal and interest amounts (not in its entirety) of the reduced debt. In order to comply with this commitment, Mexico borrowed \$3.8 billion from the Bretton Woods institutions, \$2 billion from the World Bank and \$1.8 billion from the IMF. With that money, it purchased zero coupon bonds from the U.S. Treasury, which it then pledged as collateral to guarantee payment of debt service payments to the commercial banks. These bonds, nominally an asset of the Mexican Central Bank, are now on deposit with the New York Fed pursuant to an escrow agreement among the commercial banks, the Fed and the Mexican Government. Should Mexico fail to make

timely payments to the commercial banks, the banks, theoretically could demand of the Fed that in accord with the terms of the escrow agreement, the zero coupon bonds be released to the banks.

Mexico, of course, would still owe $3.8 billion to the Bretton Woods institutions, but it would no longer own the asset it had purchased with the funds it had borrowed: the zero coupon bonds. In any future financial crisis, Mexico is in a much weaker negotiating position with the private commercial banks than it was in 1982, when it defaulted on its payments to those banks. At that time, the banks had no comparable security to which they could recur.

In the short term, the pressure to devalue and constrain imports would probably be irresistible. And it is equally predictable that you in the Congress would be blamed for precipitating the inevitable financial crisis resulting from a failure to pass the NAFTA. Such blame would be misplaced. The real culprits are those who have encouraged the Mexican authorities to believe that they can have it both ways: they can follow a low wage/labor repression and environmental degradation strategy designed to attract foreign, i.e U.S., capital to finance Mexican development, and, at the same time, have unrestricted access to the United States market for the goods and services produced under those conditions.

That is the basic deal that George Bush negotiated and it is the deal that Bill Clinton has rejected. If the deal does not meet the Clinton standard set forth in the Raleigh speech, it

should be rejected, the resulting run on the peso notwithstanding. The Salinas Government (and the PRI) might then be in political trouble in Mexico, but, increasingly, Mexico is not the PRI. We should not demean Mexico by placing all of our chips on Salinas and the PRI. The stakes are too great for the American factory worker and his or her family. Supplemental labor and environmental agreements which leave things essentially the way they are create an unfair competitive advantage for Mexico in attracting investment capital.

The Cold War is over; it is no longer possible to panic the American people with the fear that the communists will take over Mexico. What I sense is that there is an increasing tendency to substitute general chaos for the communists. I don't know how many divisions general chaos has in Mexico, but it isn't enough to compensate for the harm that will be done in this country by agreeing to a NAFTA which fails to effectively address worker rights and the degradation of the environment in Mexico. I hope that you will not be diverted from these central issues by the prospect of a financial crisis, which, however real, will neither shake Mexico's political stability or its fundamental relationship with the United States.

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**STATEMENT OF GREGORY WOODHEAD, TRADE TASK FORCE
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
ON
"EFFECTS OF DEVALUATION OF THE MEXICAN PESO"**

May 20, 1993

Thank you, Mr. Chairman, and members of the Committee for the opportunity to present the views of the AFL-CIO on the impact of a devaluation of the Mexican peso. The Chairman is to be commended for his recent article in Roll Call in which he expressed real concern for the dramatic and stark differences between Mexico and the U.S. in approaches to democracy, human rights and justice in the work place. The AFL-CIO shares those concerns and believes that the proposed NAFTA, if implemented, would do little to improve those conditions, while putting at risk the jobs and incomes of millions of U.S. workers.

I. Political Context

The question of currency realignment in Mexico must examined within the context of the proposed North American Free Trade Agreement (NAFTA) and Mexican President Salinas's attempt to choose his successor. One of the many deficiencies of NAFTA is that the agreement specifically excludes exchange rate policies from coverage.

For Mexico, NAFTA is an investment program. Ratification of NAFTA is of crucial importance to Mexican development strategy because it will guarantee multinational corporations complete access to the lucrative U.S. market, and at the same

time, provide extensive protections for existing foreign investment in Mexico, lowering risks and increasing business confidence.

It is unnecessary for me to speculate here on the technicalities of how, when, and how much the peso will devalue. Nevertheless, it is clear that two conflicting forces are acting on the value of the peso, one economic and one political.

First, there is significant economic pressure to devalue the peso relative to the dollar. The overvalued peso is contributing to a surge in imports, pushing Mexico's current account balance into deficit. Secondly, there is extreme political pressure to maintain an overvalued peso, at least until President Salinas's successor has been "elected" and NAFTA ratified. To devalue sooner would reduce confidence in the Mexican development program, place the issue of succession in doubt, and raise another obstacle to the implementation of NAFTA.

The recent history of Mexican exchange rate policy, together with the present economic pressure, suggests that devaluation is inevitable. When it occurs, it will affect different segments of society differently on both sides of the border. The focus of this testimony is on identifying the winners and losers following a peso devaluation.

II. Background

A. History of Peso Devaluations

Inflation adjusted interest rates in the U.S. jumped from 1.4 percent in early 1980 to 9.7 percent in August 1981. This increase dramatically forced up the cost of servicing Mexico's external debt. In mid- 1981, world oil prices fell, leading to fears of a peso devaluation and to a sharp increase in capital flight.

In February 1982, the Mexican government announced an "Economic Adjustment Program" which included a 40 percent devaluation of the peso\dollar rate, severe import restrictions, increased public sector prices and large cuts in public sector spending.

By the end of 1987, there were four traumatic devaluations of the peso in just over a decade with Mexico trapped in a vicious cycle of peso overvaluation, then sharp devaluation inflaming inflation, leading to peso overvaluation, then devaluation and more inflation, etc. In February 1977, the peso devalued from the fixed rate of US $1 = 12.5 pesos to US $1 = 22.7 pesos and by the end of 1987 to US $1 = 2209 pesos. It continued to devalue to US $1 = 3100 pesos by the end of 1992.

In December 1987, Mexico introduced the Economic Solidarity Pact (Pacto) which combined restrictive monetary and fiscal policies with a tripartite agreement on prices and wages and further trade liberalization measures. In addition, the government adopted an "equilibrium" exchange rate policy, and the peso\dollar rate was initially allowed to devalue at a steady rate of 1 centavos per day. During the period from 1983-1988, real Gross Domestic Product growth remained flat, and inflation averaged 93 percent per year.

Since President Salinas came to office in December 1988, there has been a significant deepening and broadening of economic reforms. The "Patco" with business and trade unions was continued and certainly contributed to lowering the rate of inflation.

Salinas also gave high priority to rescheduling Mexico's external debts. Under the auspices of the March 1989 Brady Plan, an agreement was reached on a voluntary

approach to debt and debt service reduction backed by guarantees from the World Bank, the IMF and other sources, mainly Japan. The peso continued to devalue against the dollar, but at a much slower rate during the Salinas term of office.

B. Current Peso Overvaluation

There is now substantial economic pressure to devalue the peso. In 1992, Mexico's merchandise trade deficit jumped to $21 billion and the trend is to grow further. With devaluation running at a rate of 2.5 to 4.0 percent a year, the current devaluation rate does not offset the difference between U.S. and Mexican rates of inflation. According to the Journal of Commerce, "an overvalued peso reflects a deliberate Mexican effort to contain inflation." In the opinion of Latin Finance, as productivity increases in Mexico slow down, there will be more pressure to devalue the peso according to the differential in interest rates between the two countries.

Gonzalez-Archiga of the Mexican Stock Exchange claims the peso is "grossly overvalued and likely to become more so." International economist, Jonathan Heath says "if the market thinks the peso is overvalued, it's overvalued." Gary Hufbauer of the Institute for International Economics anticipates a devaluation in the 10-20 percent range after the presidential elections of August 1994. This alone will probably eliminate the current U.S. trade surplus with Mexico.

C. Experience of the U.S.-Canadian Free Trade Agreement

Following the 1988 Free Trade Agreement, the Canadian dollar--representing the relatively high-wage country--appreciated against the U.S. dollar from 75 cents to 89 cents. Although it is difficult to separate the effects of the FTA from the effects of currency realignment, the Canadian experience has provided some important lessons.

First, currency realignment affects the location of swing manufacturing plants. For example, the decision to close a Caterpillar factory in Canada was affected by the stronger Canadian dollar, because it changed the relative cost of operation. If there is an overcapacity in the overall production of a multi-national corporation, an overvalued currency will add to the logic of which plant to close.

Multi-national corporations are re-evaluating their operating strategies in light of currency shifts. With the FTA in place, a corporation such as Caterpillar can shut down manufacturing plants in Canada and still have full access to the Canadian market.

Secondly, the lesson to be learned by U.S. workers from their Canadian brothers and sisters is that "free trade" agreements and currency devaluations are a lethal combination. Since the implementation of the FTA, Canada has lost 20 percent of its employment in manufacturing.

It is clear from the Canadian experience, as well as the European Community's attempts to establish a unified currency, that currency valuation becomes an important economic variable in the dynamic process of geographic economic integration. When Mexico, the low-wage country, is allowed to devalue its currency,

the decrease in the cost of operating will further encourage the movement of U.S. and foreign manufacturing to Mexico.

III. Effects of Currency Devaluation

A. Effects on the U.S. Business Community

Export Slowdown

As a consequence of peso devaluation, the price of U.S. made products purchased with pesos will rise and therefore slow down U.S. exports to Mexico. The current surge in exports to Mexico will come to a halt and the balance of trade with Mexico will return to the historic pattern of trade deficit. (see Chart 1.)

Production Costs Lowered

A peso devaluation will reduce the cost of producing in Mexico relative to producing in the U.S. Purchases of land, manufacturing plants and equipment which are denominated in pesos will be cheaper after devaluation. The key factor of labor costs will decrease relative to labor costs in the U.S. According to Spriggs and Blecker of the Economic Policy Institute, at a more realistic exchange rate, the Mexican real hourly compensation for production workers in manufacturing would be only about one-tenth of the U.S. For Mexican workers in the maquiladora plants, the typical weekly wage of $60 would be reduced to $48.

The decrease in overall costs of producing in Mexico will only provide added incentive for U.S. multinational corporations to relocate their manufacturing operations south of the border. In addition, the lower costs for firms that relocate to Mexico

place firms who cannot or choose not to go south at a competitive disadvantage. Small business will be particularly hard hit. The peso devaluation will provide added rewards to multi-national corporations that pursue a low-wage, run-away from labor and environmental standards strategy.

B. Effects on Workers in the U.S.

Export Industries

Following a peso devaluation, the slowdown in exports to Mexico will eliminate thousands of jobs in U.S. export industries. When the merchandise trade balance with Mexico resumes its historic deficit position, it will cause the loss of thousands of U.S. jobs.

Factory Relocation

A growing number of international economists recognize NAFTA as a trade and investment arrangement that will only exacerbate the movement of U.S. factories to Mexico. The Bush negotiated agreement will lock into legal status a business climate in Mexico that will reduce the risk for U.S. investors who move south of the border. Over the longer term, the increase in direct foreign investment in Mexico, geared to export to the lucrative U.S. market will cost an estimated 550,000 jobs in the U.S., primarily in manufacturing industries. It should be noted that international economic think tanks such as the Economic Strategy Institute and the Institute for International Economics both project long-term net job loss as a result of NAFTA.

Last year, a Wall Street Journal survey of 455 senior executives of manufacturing companies indicated eagerness to expand in Mexico. Fifty-five percent of executives from companies with at least $1 billion in sales said that, if NAFTA goes through, it is very likely or somewhat likely that they will shift some production to Mexico within the next few years.

The devaluation of the peso will be the straw that breaks the camel's back - as it will only add to the economic justification for their firm relocating to Mexico. For U.S. workers, especially in manufacturing industries, devaluation can only mean the loss of more jobs. Following the crisis of 1982, the dramatic devaluations of the peso contributed directly to the surge in foreign investment in Mexico which resulted in the maquiladora program. This "free trade" zone along the Mexican side of the border now consists of approximately 2,100 factories employing 525,000 workers who's jobs used to be in the U.S. Combining "free trade" agreements and currency realignment will produce a double-whammy for workers in the U.S., much the same as the FTA did for manufacturing workers in Canada.

Dislocated Workers

For the U.S. worker whose job moves to Mexico, it is unlikely that he or she will find employment opportunities that pay wages and benefits anywhere near the level paid by the job lost. Manufacturing workers who lose their jobs to Mexico, especially those with years of seniority, will inevitably encounter severe economic hardship and reduction in the standard of living for their families. For the 45-55 year

old worker who has only held a job in manufacturing, trade related job dislocation is a devastating life experience.

Even when a trade dislocated worker manages to qualify for Trade Adjustment Assistance, completes a training program, and is fortunate enough to find employment in an economy that is not adding jobs, experience shows that wages and benefits will be reduced by approximately 50 percent in the new job. Retraining from a manufacturing job paying $11.75 per hour with full benefits for an unspecified service sector job paying $7.50 per hour with few benefits should not be considered progress. Although the AFL-CIO supports efforts to strengthen and increase funding for the Trade Adjustment Assistance program, the primary emphasis of U.S economic policy should be on measures to keep jobs in the U.S.

Trade related economic restructuring that lowers wages has produced a devastating effect on local, state, and federal tax revenues. More alarming is the under-consumption effect, wherein overall demand for goods and services is depressed because workers are not being paid enough to purchase the products they are making.

The high-skill, high-wage work place envisioned by Secretary of Labor, Robert Reich is incompatible with low-wage strategy of U.S. multi-nationals. As a nation, we must make a conscious decision about which way we are going to proceed, and Congress must enact policies to move in right direction.

Wage Effect

The second, and more devastating effect--one that will impact on the majority of U.S. workers--is that peso devaluation, which reduces wages in Mexico relative to wages in the U.S., will put additional downward pressure on U.S. wages.

It is estimated by economist Edward Leamer that NAFTA will reduce the wages of about $20,000 for the 70 percent of U.S. workers who are not in high skill, high technology jobs by approximately $1000 per year. The relative cheapening of Mexican labor through peso devaluation will only hasten the decline in real wages in U.S. manufacturing. The downward pressure on wages is especially true in collective bargaining where the company's threat of moving to Mexico must be viewed as real by union negotiators faced with concessionary demands.

C. Effects on Mexico

Exports

The business community, especially export industries, eagerly await the positive impact of the upcoming devaluation of the peso. The lower relative cost of labor will place manufacturers located in Mexico in a more competitive position vis-a-vis the U.S. manufacturer. Once the increase in direct foreign investment in Mexico has established a comprehensive export platform to the U.S. market, a lowering of relative labor costs through peso devaluation will only increase the flow of Mexican exports to the U.S. The surge in Mexican exports will benefit Mexico by providing the opportunity to earn hard currency.

Mexican Workers

It is clear that the cost of peso devaluation will be born mostly by Mexican workers. Mexico has one of the most distorted levels of income inequality in the world. The top 10 percent of Mexican workers make as much as the bottom 70 percent. Mexico has a poverty rate of approximately 40 percent, and an effective unemployment rate of 20 percent.

The National Autonomous University of Mexico estimates that the minimum wage has lost 72 percent of its buying power since Salinas took office. Out of a work force of 24 million, two-thirds of the workers make less than $10 a day--when the cost of basic subsistence for a typical family of 5 is now approximately $16 a day. In other words, the majority of Mexican workers fortunate enough to have jobs make far less than what is required to support a family with basic needs. For example, the costs of children to school includes uniforms and books, items beyond the means of many Mexican poor families. The result is a growing disparity in education between the rich and the poor, and increasing exploitation of child labor to have the family survive.

The devaluation of the peso will place an uneven burden on the majority of low paid Mexican workers. A devalued peso will increase the price of products made in the U.S. beyond the reach of millions of Mexican consumers.

Out of 86 million people, only two million of the most affluent have access to international luxury goods and international travel. Another 14 million people can be categorized as middle class consumers in the formal sector who have disposable

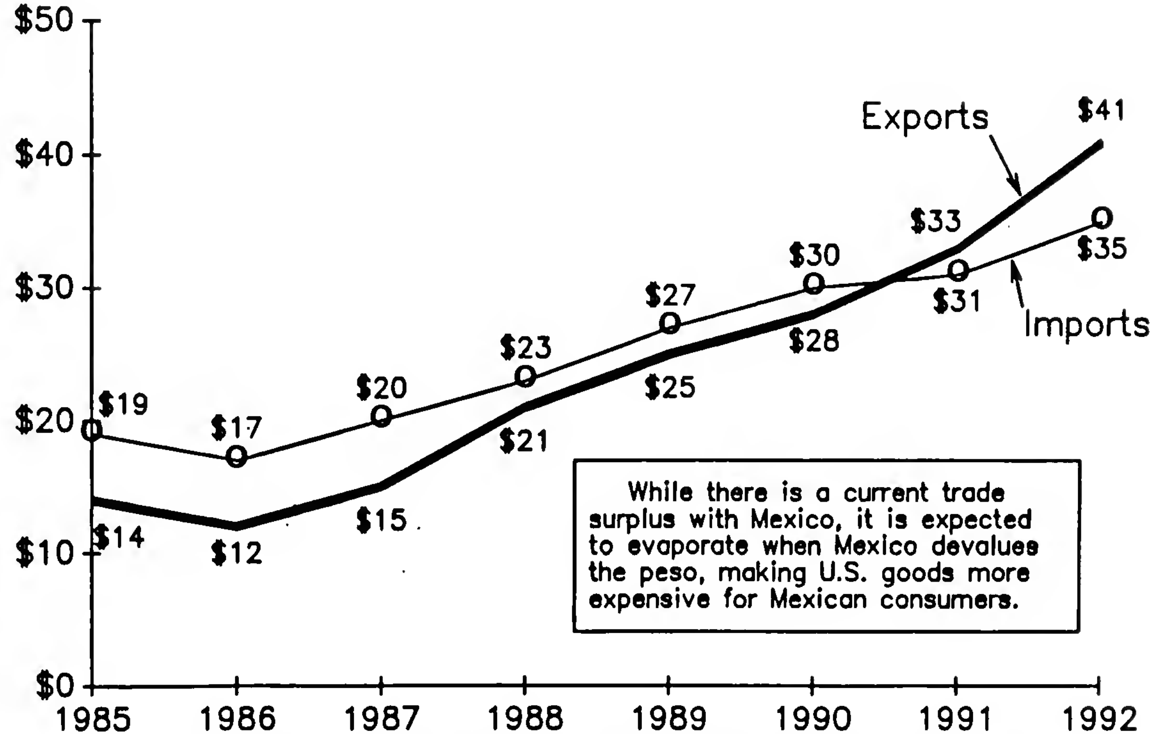
income to buy consumer goods. The remaining 70 million people live at or near the subsistence level of existence.

IV. Conclusion

The question of currency devaluation must be examined in light of both political and economic factors. NAFTA represents a never-before tried, high-risk experiment in which two countries at far different stages of economic development and democratic rights are attempting to merge their economies. The danger in further peso devaluation lies in the inherent downward pressure on wages for workers in both countries and additional incentives for U.S. companies to relocate to Mexico. In sum, the combination of peso devaluation and NAFTA will be detrimental to the interests of workers on both sides of the border.

CHART 1.

Merchandise Trade with Mexico 1985 - 1992 (billions of dollars)



Capital goods (plants and equipment) and intermediate goods (parts used to make final products which are then sent back to the U.S.) account for 85 percent of exports to Mexico. A large portion of trade with Mexico consists of shipments between affiliates of U.S. corporations.

Source: Department of Commerce

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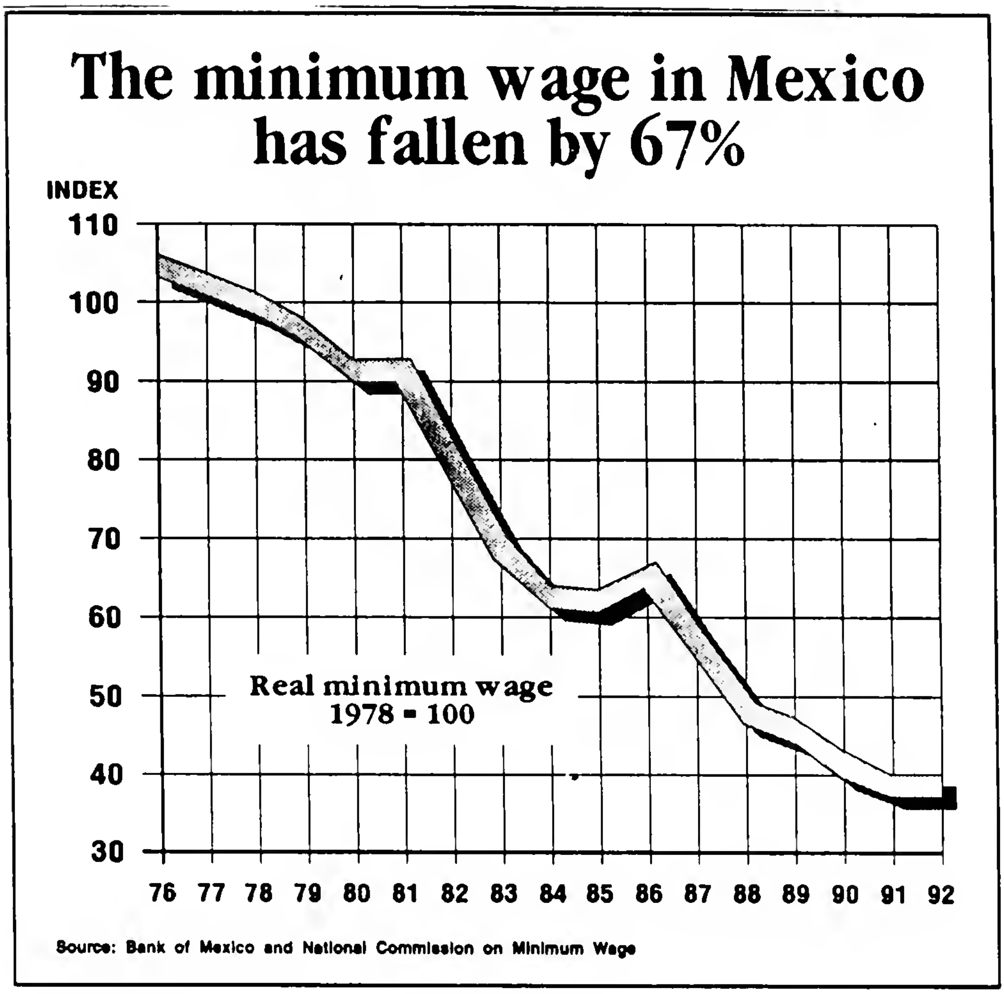

In the U.S., average weekly earnings of production and nonsupervisory workers have declined by 7.2% in real terms since 1980.

During the same time period, the U.S. minimum wage has fallen, from 48% of average hourly earnings to only 40% today.

NAFTA supporters claim that Mexican consumers will have the purchasing power to create enough U.S. export related jobs to offset any job losses. However, the 50 percent decline in real wages of Mexican workers in the past decade means less purchasing power for those workers, and thus a loss of export markets for U.S. manufacturers. Mexico has an effective 20 percent unemployment rate, a 40 percent poverty rate, and a gross domestic product one-twentieth of ours.

Negotiating Imperative:

Mexico needs to provide a minimum living wage for workers who occupy the bottom of the wage ladder. Of a work force of 24 million, 29 percent have no income or receive less than the minimum wage of $4.67 per day as of January 1, 1993.[2]

Negotiations could be based on the Mexican constitution, which states (article 123, section VI) that:

> Minimum wages (in Mexico) must be sufficient to address the normal needs of a family--material, social and cultural needs--as well as to provide the basic education for the children.

This is not inconsistent with ILO Convention NO. 131 Concerning Minimum Wage Fixing, 1970, ratified by Mexico, which states (Article 3a) that the elements to be taken into consideration shall include:

> the needs of workers and their families, taking into account the general level of wages in the country, the cost of living, social security benefits, and the relative living standards of other social groups;

Relation to Present Cost of Living:

According to a study carried out by the economic analysis faculty at the National Autonomous University of Mexico (UNAM), the price of the "basic basket" of consumer goods is currently in excess of three minimum wages. As of November 1992, the daily minimum wage was 13,330 pesos ($4.30), compared to 45,322

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[2] Another 36 percent receives between 1 and 2 times the minimum wage. In other words, 65 percent of the work force take home less than $3,400 a year.

pesos ($14.30) required for purchasing components of the basic goods basket which will meet the daily basic needs of a family of five.

These figures should be considered in the context of larger average family size in Mexico where the standard family unit includes six members.[3] Prof. Luis Gonzales Souza of UNAM claims the minimum wage just barely provides enough money to buy food for one person, leaving little or nothing for the rest of basic needs such as housing, health care and education. For example, the costs of sending children to school includes uniforms and books, items beyond the means of many families. The result is a growing disparity in education between the rich and poor, and increasing exploitation of child labor to survive. The reality for millions in Mexico is abject poverty, poor diets where beef is a rarity, and basic needs going unmet.[4]

In the U.S., the minimum wage of $4.25 an hour, is substantially below the $6.97 per hour needed to achieve the poverty level for a family of four.

Relation to Wages in Manufacturing:

If the trend for 1987-1991 continues, the average hourly cost of compensation in manufacturing in Mexico is estimated to be $2.72 for 1993. Assuming that benefits constitute 12 percent of compensation costs in Mexico, average wages in Mexico are estimated to be $2.40 in 1993.

A conservative international standard for fixing the minimum wage is at least 50 percent of average wages in manufacturing.[5] If this target were to be met, minimum wages in Mexico (approximately .68 cents per hour) need to double immediately.

In the U.S., 50 percent of the average wage in manufacturing of $11.45 would lead to a minimum wage of $5.73.

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[3] According to Dr. Luis de la Calle, economic advisor to President Salinas, 50 percent of Mexico's population is under the age of 20.

[4] In 1989, the top 10 percent of Mexicans earned as much as the bottom 70 percent.

[5] France has one of the most well-known forms of national minimum wage in Europe - the SMIC. It is adjusted in line with both inflation and increases in the purchasing power of average pay and is now approximately $6.36 per hour.

Options:

1. Mexico's minimum wage needs to increase to 300 percent of its present level just to buy what it could buy in 1976.

2. Mexico's minimum wage needs to increase to 333 percent of its present level to be able to buy the "basic basket" of consumer goods which will meet the basic needs of a family of five.

3. Mexico's minimum wage needs to double immediately in order to provide at least 50 percent of the average wage in manufacturing.

4. Minimum wage increases in Mexico should also account for changes in exchange rates. If the peso is allowed to devalue at an increased rate, Mexican consumers will be able to buy even fewer consumer products made in the U.S. and Canada.

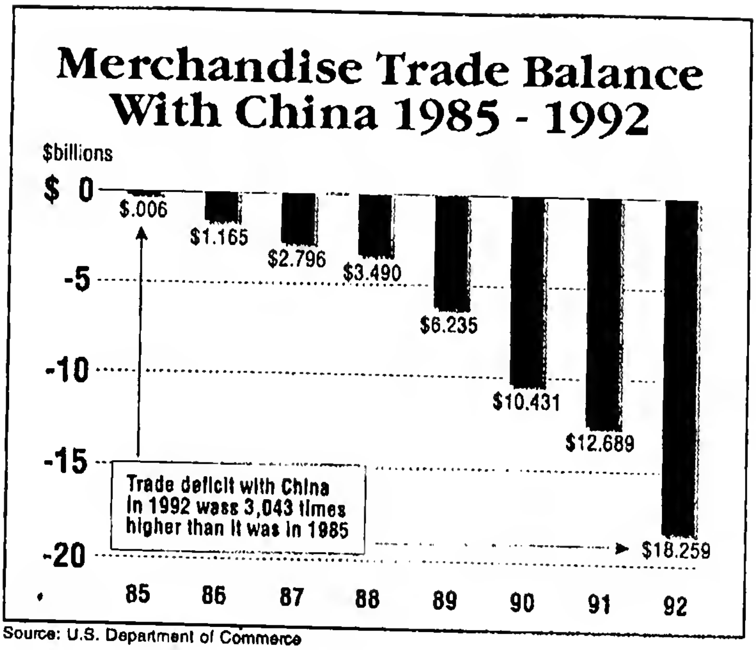
Conclusion:

NAFTA represents a high-risk experiment in untested economic policy because never before have two countries with such disparate standards of living proposed economic integration. NAFTA, as drafted will result in the loss of up to 550,000 jobs in the U.S. and depress U.S. wages <u>without any real promise for raising wages in Mexico</u>. The challenge for the U.S., Mexico and Canada is to expand trade in North America and at the same time, offer a real opportunity to upgrade wages and living standards in Mexico without compromising labor standards and wages in the U.S. and Canada. An appropriate minimum wage structure is a necessary step toward reaching that goal.

February 14, 1993

Trade Deficit With China

The danger of a low-wage country devaluating its currency can also be seen in the case of China. In January of 1993, China devalued its currency, the renminbi, by 5.7 percent against the dollar, bringing its depreciation against the dollar to 37 percent since 1989. One result is that China has boosted its exports to the U.S. by nearly 40 percent during the third quarter last year versus the same period in 1991. China now exports more goods to the U.S. than do Malaysia, Thailand, Indonesia and the Philippines combined. In fact, the $18.3 billion trade deficit with China in 1992 was 3,043 times higher than it was in 1985. (see chart)



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